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PREFACE

This publication outlines the 1972 changes in income tax legislation as they affect corporations. Its purpose is to provide some preliminary guidelines to assist officers of corporations and their advisers in understanding the basic changes in taxation concepts and the new terminology.

While an attempt has been made to explain the changes in the law in simple terms, there are areas in the publication where somewhat complex formulas complete with examples had to be discussed in order to explain their purpose and how they achieve that purpose. However, in most cases, schedules on the corporation T2 tax return and other forms available will provide adequate instructions and information to enable taxpayers to compute the taxes payable and the taxes refundable under the new Act.

The reader should keep in mind that this publication is not a substitute for the Income Tax Act as amended, nor is it, like regular interpretation bulletins, a considered opinion supported as far as possible by judicial decisions. The scope of the publication is further limited because not all of the regulations applicable to the new and revised sections of the Act had been written at the time this Guide was published.

Where this publication states that certain rules apply to corporations, the statement should not be construed as extending or precluding the application of those rules to individuals.

The corporate tax rates discussed or used in examples are those rates given in the Income Tax Act before provincial tax abatement, unless otherwise stated.

An explanation of the effect of the Income Tax Application Rules, 1971, appears where appropriate. References to the relevant provisions in the new Income Tax Act appear at the end of the respective paragraph in bold italic—***150(4)***. Where the reference is to the Income Tax Application Rules, 1971, the section number is preceded by designation ***ITAR***, also in bold italic.

A reference to ***N.R.*** means a reference to News Releases issued by the Department of Finance in order to assist planning by taxpayers before the reform legislation was passed, and the appropriate regulations subsequently prescribed. In this publication, references will be found, where appropriate, to the following News Releases:

- Capital cost allowances on real estate, No. 71-115, released September 22, 1971;
- Mining and petroleum regulations, No. 71-80, released July 6, 1971; and
- Foreign affiliate regulations, No. 71-94, released August 4, 1971.

Upon issuance of the prescribed regulations, reference should be made only to them.

SUMMARY

RULES APPLICABLE TO ALL CORPORATIONS

• Corporations resident in Canada continue to be taxable in Canada upon their world income.

• One-half of the cost of goodwill and similar intangible assets will be deductible at a rate of 10 per cent per year on a declining balance. One-half of the proceeds of sale of such assets will be included in income. As the cost of such assets of a business carried on at the start of the system cannot be deducted, special transitional rules reduce the amount to be included in income if these assets are sold between January 1, 1972, and December 31, 1983.

• Membership fees in recreational and social clubs and the expenses of a yacht, camp or lodge are not deductible.

• Losses created by capital cost allowance deductions on rental property are not deductible from non-rental income.

• Rental buildings costing $50,000 or more that are acquired after 1971 must be placed in separate capital cost allowance classes.

• Corporations will be allowed a full deduction for interest paid on money borrowed to purchase shares in other corporations.

• A portion of interest payable in respect of debts owing to certain non-residents may not be deductible if the debt owing by the corporation exceeds three times the shareholders' total equity in the corporation.

• Discounts in respect of interest-bearing obligations issued after June 18, 1971, may be deductible if the discount is 3% or less and the annual yield does not exceed 4/3 of the interest rate. If the discount or yield exceeds these limitations, only one-half the discount will be deductible.

• Special rules limit deductions for carrying charges on vacant land. Such charges that are disallowed may be added to the cost base of the land.

• Foreign state income taxes may be either deductible in computing world income subject to Canadian tax or may qualify as a foreign tax credit.

• Interest received from a non-resident corporation in respect of an income bond will be treated as a dividend only if the non-resident is not entitled to deduct the interest in computing the income subject to tax in the country of its residence.

• One-half of capital gains (taxable capital gains) realized after 1971 are included in income and taxed at normal corporate rates. One-half of capital losses (allowable capital losses) are deductible from taxable capital gains in computing income.

• A corporate capital gain is measured from the greater of the cost or valuation day value of an asset and a corporate capital loss is measured from the lower of the cost or valuation day value of an asset.

• One-half of capital losses (allowable capital losses) may be carried back one year and forward any number of years, being applied against net taxable capital gains, until absorbed.

• A corporation paying a dividend in kind is deemed to have disposed of the property transferred to the shareholder at fair market value and may realize a taxable capital gain.

• Special new rules govern the taxability of corporations granting options to purchase shares, bonds or debentures of the corporation and receiving consideration therefor.

• The limit on deductible charitable donations is increased to 20 per cent of income from 10 per cent of income. Donations to qualifying national amateur athletic associations will be deductible in the same manner as gifts to qualifying charitable organizations.

• Losses are categorized as non-capital losses, net capital losses and restricted farm losses. Non-capital losses may be carried back one year and forward five years and applied to reduce income from any source. Net capital losses may be carried back one year and forward indefinitely and applied to reduce net taxable capital gains. Restricted farm losses may be carried back one year and forward five years and applied to reduce farming income.

• Where control of a corporation changes, unabsorbed net capital losses are no longer available to reduce net taxable capital gains. Where control of a corporation changes and the business in which unabsorbed non-capital losses were sustained is not carried on, such non-capital losses are no longer available to reduce income.

• If more than one type of unabsorbed loss being carried back or forward is available in a taxation year the order of priority for deduction is restricted farm loss, non-capital loss and net capital loss.

• Transitional provisions ensure that business losses sustained prior to 1972 may be carried into the new system as non-capital losses and that a non-capital loss sustained in 1972 may be carried back to 1971 as a business loss.

• The general rate of tax for corporations is 50 per cent, reducing by one percentage point annually to 46 per cent in 1976.

• A corporation may elect to pay a special 15 per cent tax on its 1971 undistributed income on hand and add the amount on which it elected (less the 15 per cent tax) to tax-paid undistributed surplus on hand. A dividend paid out of tax-paid undistributed surplus on hand is tax-free to a shareholder but reduces the cost base of the shareholder's shares. Once the special 15 per cent tax has been paid on the full balance of 1971 undistributed income on hand, the corporation may pay a dividend out of 1971 capital surplus which is tax-free to the shareholder but reduces the cost base of the shareholder's shares. If a dividend, or a part of one, elected to be paid out of 1971 tax-paid undistributed surplus on hand, exceeds the balance of that account, the corporation must pay a special tax equal to the excess. Similarly, a tax is payable equal to the excess of any amount specified in an election to pay a dividend from capital surplus on hand over the balance in the account. In addition, if an election to pay a dividend from capital surplus on hand is made when the corporation has a balance of 1971 undistributed income on hand, a special tax becomes payable equal to that balance or the amount of the dividend if it is the lesser.

SPECIAL RULES APPLICABLE TO PRIVATE CORPORATIONS

• A small business deduction is allowed to reduce the tax payable by a Canadian-controlled private corporation. The maximum deduction in any year may reduce to 25% the tax payable on active business income of $50,000 or less. A corporation may become ineligible for the deduction when its active business income after 1971 totals more than $400,000. Payment of dividends will, however, permit most corporations to continue to receive the deduction even though total business income over the years is considerably more than that.

• If earnings subject to the small business deduction are not used in the corporation's active business or distributed as taxable dividends to shareholders, but are used to acquire ineligible investments, the corporation must pay a special tax which will be refunded to the corporation when the ineligible investments are disposed of or, in certain cases, when taxable dividends are paid to shareholders.

• If a Canadian-controlled private corporation that has claimed the small business deduction becomes controlled by non-residents, it must pay a special tax which equals the benefit previously received from the small business deduction.

• Dividends received by one corporation from another corporation generally continue to be exempt from tax. However, dividends received by private corporations from non-subsidiary corporations are subject to a special 33 1/3 per cent tax which is fully refunded to the corporation as taxable dividends are paid to shareholders; for every $3 of dividends paid, $1 of tax is refunded.

• Investment income (including net taxable capital gains and net income from non-active businesses) of a private corporation is subject to tax at the normal corporate rate of 50 per cent (1972). Up to 25 percentage points of the tax paid in respect of the investment income is refundable to the corporation as taxable dividends are paid to shareholders; for every $3 of dividends paid, $1 of tax is refundable.

• The above two refundable taxes are designed to ensure that income earned by a private corporation is not subject to tax at the corporate level at rates substantially lower than rates imposed on income earned directly by individuals and, that, generally, the total tax payable by a private corporation and its individual shareholders after income is distributed is no greater than the tax that would have been payable had the shareholders personally received the income.

• A private corporation may accumulate certain non-taxable income (including the non-taxable half of net capital gains) in a capital dividend account, and, if the corporation so elects, it may pay a tax-free dividend (capital dividend) to its shareholders from this account. This tax-free dividend does not reduce the cost base of the shareholder's shares. If a corporation elects to pay a capital dividend of an amount in excess of the balance in the capital dividend account, it is liable to a tax equal to the excess.

DEEMED DIVIDENDS AND DESIGNATED SURPLUS

• Amounts paid to shareholders in connection with a reduction in the share capital of a corporation are first regarded as a non-taxable return of capital to the extent of the reduction in the share capital and then as a distribution of earnings. In general where the paid-up capital of a corporation has been reduced, the excess of amounts paid to shareholders over the paid-up capital of their particular share is deemed to be a dividend.

• Special rules provide that where a corporation redeems or acquires any of its shares at a premium, the corporation, in certain circumstances, pays a tax in respect of the premium. Such tax is paid by the corporation in lieu of having the premium treated as a deemed dividend.

• A corporation will pay a special tax of 25% on dividends received out of the designated surplus of its subsidiary.

• The provisions regarding the computation of designated surplus and control period earnings are continued subject to certain modifications.

• The portion of the surplus of private corporations that is represented by investment income is not included in designated surplus.

• Where the control of a parent corporation is acquired by another corporation, the designated surplus of the parent is increased by dividends received from its subsidiaries that were paid out of the subsidiaries' surplus on hand at the time when control of the parent was acquired.

• Special new rules are applicable in calculating the designated surplus of a company formed as a result of an amalgamation.

ROLLOVERS AND REORGANIZATIONS

• On the incorporation of a proprietorship or partnership, and on certain corporate reorganizations, realization of capital gains may be deferred, provided the person transferring the assets to a corporation retains a certain percentage interest in that corporation.

• Provision is made that, on amalgamation, all asset accounts, tax reserve accounts, special distribution accounts etc. of the predecessor companies are carried over and added together for purposes of the new corporation.

• When a wholly-owned subsidiary is wound up into its parent, the subsidiary will be generally deemed to have disposed of its property at its cost and the parent deemed to have acquired such property at that amount.

SPECIAL CORPORATIONS

Mining and Petroleum

• Taxpayers whose principal business is not mining or petroleum will be allowed more generous deductions for Canadian exploration and development expenses.

• All taxpayers will be allowed more generous deductions for foreign exploration and development expenses.

• Acquisition of mining properties and royalty interests will be treated as exploration and development expenses, and proceeds on disposals of such properties will be fully taxable subject to transitional rules for those owned at December 31, 1971.

• Three year tax exemption for new mines will be withdrawn after 1973 and replaced by an accelerated write-off of capital equipment and on-site facilities, including townsite facilities such as sewage plants, roads, hospitals and schools. The accelerated write-off will also apply to a major expansion of an existing mine where capacity is increased by at least 25 per cent.

• The present system of automatic percentage depletion for operators and non-operators will continue until 1976. After 1976, depletion will be based on amounts expended on eligible expenditures since November 7, 1969. Taxpayers will be allowed $1 of depletion for each $3 of eligible expenditures with a limit of 33⅓% of production profits per year. For this purpose, royalty income will be deemed to be production profits. This new system will apply to profits from gold and coal mining after 1976 as well.

• A federal corporate tax abatement on mining profits of 15 percentage points will be introduced. This abatement which commences in 1977 will also apply in the Yukon and Northwest Territories.

Mutual Funds and Investment Corporations

• The main objective of the new legislation is to treat mutual funds and investment corporations essentially as conduits between their shareholders/investors and the sources from which their income is derived.

• An open-end mutual fund corporation or a closed-end investment corporation may continue to elect to qualify for preferential treatment as an "investment corporation".

Co-operatives and Patronage Dividends

• Under the old Act a co-operative was exempt from tax for the first three years of its existence. This exemption is withdrawn. Co-ops may continue to deduct patronage dividends; but the deduction which could not reduce taxable income below 3 per cent of capital employed by members now has no limitation. However, any patronage dividend in a year in excess of $100 will be subject to a withholding tax of 15% which may be applicable against tax payable by members or refunded.

Credit Unions and Caisses Populaires

• Caisses populaires and credit unions were previously exempt from tax. Starting on January 1, 1972, they will be taxed and permitted reserves for doubtful debts and market liquidity similar to those allowed to banking institutions. There is also a special tax abatement to reduce normal tax payable on income allocated to certain reserves.

Incorporated Professionals

• The new Act requires that these taxpayers record income when fees are billed and expenses when they are incurred for fiscal years ending after December 31, 1971. Because of the difficulty in valuing unbilled time, the legislation provides that work in progress need not be brought into income unless the taxpayer chooses to do so.

• To provide for an orderly changeover, accounts receivable at the start of the system will be brought into income over a number of years. Specifically, these taxpayers will pay tax on the higher of their income computed under the cash basis or billed basis each year, calculated cumulatively, until the original total of deferred income has been eliminated. The deferred income of professional corporations must be reduced by at least 10 per cent each year on a cumulative basis.

INTERNATIONAL INCOME

Foreign income of Canadian Corporations

• Many changes in taxation of international income do not take effect until 1976. This will allow time for the negotiation of new tax treaties and for the renegotiation of existing treaties.

• Foreign tax credits continue to be available to corporate taxpayers resident in Canada in respect of taxes paid in foreign jurisdictions on their foreign income.

• Taxes paid to political subdivisions of foreign countries are deductible from foreign income or included in the foreign tax credit calculation, depending on treatment given these taxes in the foreign country.

• Foreign taxes on business income in excess of the foreign tax credit applicable may be carried forward for five years.

• The exemption from tax for foreign business corporations is being phased out over five years commencing with the first taxation year after 1971. Dividends paid by these corporations after 1971 are eligible for dividend tax credit.

• The new Act contains special rules for the taxation of income of taxpayers resident in Canada from "foreign affiliates".

• Dividends received by corporations resident in Canada from foreign affiliates continue to be exempt from tax if paid out of pre-1976 earnings. For dividends paid out of post-1975 business earnings, the exemption continues if the profits are earned in a treaty country; if earned in a non-treaty country part or all the dividends may be exempt, depending on the level of foreign taxes paid.

• After 1972 a Canadian shareholder of a foreign affiliate will be required to include in his income his proportionate share of the affiliate's "foreign accrual property income", whether or not that income is distributed. Such income is limited to income from property such as investment income, or capital gains, and income from non-active businesses.

Canadian Tax Treatment of Non-Residents

• The rate of tax on non-resident-owned investment corporations remains at 15% until the end of 1975 except for the tax on net capital gains from dispositions of taxable Canadian property which is levied at the rate of 25% commencing with the 1972 taxation year. For 1976 and subsequent taxation years, the rate of tax on all the taxable income of the corporation will be 25%.

• Income of non-resident-owned investment corporations includes the full amount of capital gains on taxable Canadian property, but no other gains.

• Capital gains realized by a non-resident-owned investment corporation from dispositions of taxable Canadian property and of shares of another non-resident-owned investment corporation are included in the capital gains dividend account of the corporation from which capital gains dividends may be paid to non-residents without being subjected to withholding tax.

• When other dividends are paid out to its shareholders by a non-resident-owned investment corporation, income taxes, except taxes paid on capital gains from

taxable Canadian property, will be refunded to the Corporation. These dividends will be subject to the normal rates of withholding tax.

• The general rate of withholding tax on investment income paid to non-residents remains at 15% until the end of 1975, then increases to 25% unless reduced by treaty.

• The rate of withholding tax on dividends paid by a corporation with a degree of Canadian ownership continues to be five percentage points less than the general or treaty rate.

• The special branch tax paid by non-Canadian corporations will be increased to the general withholding tax rate and will apply equally to corporations whether resident or non-resident.

Chapter 1

RULES APPLICABLE TO ALL CORPORATIONS

LIABILITY FOR TAX

1.001 Part I of the new Act, like the old Act, renders a corporation resident in Canada liable to Canadian income tax in respect of its world income. Provisions in the Act for the deduction of foreign tax credits may reduce the amount of Canadian tax payable. Generally, a corporation is considered to be resident where its central management and control is located. In addition, the new Act, like the old Act, contains the following two rules relevant to determining the residence of a corporation, which are

1. if incorporated on or after April 27, 1965, the corporation is deemed to be resident in Canada throughout each year simply by being incorporated in Canada and regardless of any other factors,

2. if incorporated on or before April 26, 1965, the corporation is deemed to be resident throughout a year if, in that year or in any one of the corporation's preceding taxation years that ended after April 26, 1965, it was factually resident in Canada according to the general rule of law (described above), or it carried on business in Canada.

250(4)

1.002 As in the past, a non-resident corporation carrying on business in Canada is subject to Canadian income tax on its taxable income earned in Canada. This rule continues, subject to any restricting or exempting provisions contained in tax treaties entered into by Canada and other countries.

1.003 The new Act introduces a tax on non-resident persons, including corporations, that have disposed of a "taxable Canadian property" in the year or a previous year. At present, many of Canada's international tax treaties restrict the taxation of non-residents on capital gains made in Canada. Accordingly, existing tax treaties that contain such restrictions will require amendment before this new rule can be fully applied to residents of those treaty countries. It is anticipated that re-negotiation of existing tax treaties will be completed by 1976. A discussion of the taxation of non-resident persons is to be found in Chapter 7.

2(3)

DETERMINATION OF INCOME

1.004 The new Act continues many of the rules contained in the old Act for computing the income of a corporation. In addition, the new Act introduces several new rules relevant in determining the income of all corporations and it is these new rules applicable to all corporations that will be dealt with in this chapter. Special additional rules relevant in determining the income of certain special status corporations are dealt with in Chapter 6.

1.005 Under the new Act, a taxpayer is required to compute his income or loss from each source as though he had no other sources of income or loss. The Act sets out four sources of income, as follows:

1. Income or loss from an office or employment.
2. Income or loss from a business or property.
3. Taxable capital gains and allowable capital losses.
4. Other sources of income under the Act.

The new rules relevant in computing the income of all corporations will be discussed under the source headings (2) and (3) above which are applicable to corporations.

3, 4

INCOME OR LOSS FROM A BUSINESS OR PROPERTY

Goodwill and Other "Nothings"

1.006 The term "nothings" is commonly used to describe certain expenditures made for the purpose of producing income from a business which are neither deductible as an expense nor deductible by way of capital cost allowances. "Nothings" would include the cost of acquiring goodwill and the cost of acquiring intangible rights of an indefinite period, such as acquiring or defending a franchise with an indefinite period. Of all the "nothings", goodwill is the most significant. The following remarks under this heading are related to goodwill, but they apply equally to all other "nothings".

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1.007 Prior to the enactment of the new Act, a purchaser, in computing his income, was not entitled to deduct any portion of the purchase price paid for good-

will; and a vendor was not required to include in income any portion of the proceeds received for the goodwill. To provide for such deductions and inclusions in determining business income, the new Act introduces an account known as "cumulative eligible capital". The cumulative eligible capital account is somewhat similar to a capital cost allowance class for depreciable property, except that only one-half of the cost of goodwill and only one-half of the proceeds of sale of goodwill are included in this account. As will be seen, a year-end debit balance in the cumulative eligible capital account permits a taxpayer to deduct from business income an amount up to 10% of the debit balance, calculated on the diminishing balance basis. Conversely, a year-end credit balance in the account requires a taxpayer to include the amount of that credit balance in income.
20(1) (b)

1.008 It should be noted that the deductions from income and the inclusions in income in respect of goodwill are relevant in computing **business** income. Therefore, the new provisions for taxing capital gains do not apply to purchases and sales of "nothings".

1.009 The cumulative eligible capital account is composed of three elements, which are

1. one-half of eligible capital expenditures (generally, a non-deductible capital outlay made after 1971 for the purpose of producing income from a business—e.g., the cost of goodwill),

2. eligible capital amounts (generally, one-half the sale proceeds of goodwill sold after 1971 subject to transitional provisions), and

3. the total of the 10% deductions previously claimed.

It will be necessary to keep a separate cumulative eligible capital account for each business of a taxpayer. Leaving aside the transitional provisions for a moment, the following example illustrates the composition and fluctuation of a cumulative eligible capital account:

Example 1

Assume a corporation commencing business purchases a store in year one and pays $5,000 for goodwill. In year one and in year two the full 10% deduction is claimed. In year three the store is sold and $6,500 is received for goodwill.

Cumulative Eligible Capital Account

Year	Eligible Capital Expenditure	Eligible Capital Amount	10% Deduction	Cumulative Eligible Capital
1	$5,000 (½)			$2,500
1			$250 (10% x $2,500)	$2,250
2			$225 (10% x $2,250)	$2,025
3		$3,250 (½ x $6,500)		$1,225 CR

The year-end debit balance in year one and year two allow the corporation a deduction in each of these years of up to 10% of the debit balance, calculated on the diminishing balance basis. The credit balance of $1,225 at the end of year three is included in the corporation's income in that year and the cumulative eligible capital is then reduced to nil.
14(5)

1.010 If, in the above example, the corporation had purchased additional goodwill in year three (assuming the same business is carried on), one-half the additional eligible capital expenditure (i.e.—one-half the cost of the additional goodwill) would first reduce the credit balance in the cumulative eligible capital account that otherwise would be included in income ($1,225), and any excess would then create a debit balance in the cumulative eligible capital account. If the corporation subsequently ceased to carry on the business, it would be entitled to deduct any debit balance in the cumulative eligible capital account in computing income for the year in which it ceased to carry on the business. The following continuation of Example 1 illustrates the above two rules:

In year three, assume that the corporation purchases another store and pays $4,450 for goodwill. In year three the full 10% deduction is claimed. In year four, the corporation ceases to carry on the business and sells the business to a person other than a corporation controlled by it. No part of the proceeds can be attributed to goodwill.

Cumulative Eligible Capital Account

Year	Eligible Capital Expenditure	Eligible Capital Amount	Deduction	Cumulative Eligible Capital
3				$1,225 CR
3	$4,450 (½)			$1,000 DR
3			$100 (10% x $1,000)	$ 900
4	Disposal of Business		$900	Nil

The $900 is deductible in computing business income in year four.

1.011 Special rules governing the transfer of goodwill

from a corporation to a controlled corporation are dealt with in Chapter 5 on rollovers.

Transitional Provisions — Goodwill

1.012 Transitional provisions apply to determine the eligible capital amount of goodwill sold in the years 1972 through 1983, but only if the company operated before January 1, 1972. The proceeds of a sale of goodwill in 1972 will be deemed to be only 40% of the actual proceeds. Each year thereafter, the percentage of the actual proceeds deemed to be the proceeds of disposition will be increased by 5 percentage points:

1973	45%
1974	50% and
in 1983	95% after which year the transitional provision expires.

It should be noted that only half of the deemed proceeds in any year are to be credited to the cumulative eligible capital account. For example, if a company which has carried on business since 1970 were to sell goodwill in 1976, only half of 60% of the actual proceeds would be credited.
ITAR 21

1.013 The following table shows the determination of the eligible capital amount on the assumption that goodwill of a business carried on by a taxpayer on January 1, 1972, is sold for $10,000 in the years indicated:

Year of Disposal	Deemed Proceeds	Eligible Capital Amount
1972	40% of $10,000 — $ 4,000	$2,000
1976	60% of $10,000 — 6,000	3,000
1980	80% of $10,000 — 8,000	4,000
1984	100% of $10,000 — 10,000	5,000

1.014 The transitional provisions state that if the vendor and purchaser are not dealing at arm's length and the deemed proceeds of the vendor are a percentage of the actual proceeds such as illustrated above, then the amount paid by the purchaser for the goodwill (in effect, the eligible capital expenditure) is equal to the deemed proceeds of the vendor.

Entertainment Expenses

1.015 An outlay or expense made or incurred after 1971 for the use or maintenance of a yacht, a camp, a lodge, or a golf course or facility, is not deductible unless a corporation made or incurred the outlay or expense in the ordinary course of its business of providing the property for hire or reward. Membership fees (including initiation fees) in any club, the main purpose of which is providing dining, recreational or sporting facilities for its members, also are not deductible.
18(1) (l)

Capital Cost Allowances — Rental Properties

1.016 Losses created by capital cost allowance deductions on rental property are not deductible from non-rental income. This limitation on the deduction of losses applies to all buildings (including depreciable leasehold interests therein) of a corporation which are used principally for the purpose of gaining or producing rental income in the year. Since the limit applies only where rental is the principal use, it will not affect capital cost allowance on buildings used for other purposes. For example, a factory or office building which is owned by a corporation and used principally in an active business carried on by the corporation (other than a real estate rental business), will not be subject to the limitation. In applying the limit, all rental buildings owned or leased by the corporation will be regarded as a group, and as a general rule the capital cost allowances on such a group of properties will be limited to the income therefrom before deducting capital cost allowances.

1.017 An exception will be made for a corporation whose principal business is the holding of real estate, or the development or sale of real estate owned by it. Such corporations may apply capital cost allowance to income from rentals and businesses but not to the extent of creating a loss.

1.018 The rules will apply for the 1972 and subsequent taxation years, and special rules will be prescribed for taxpayers with fiscal periods ending in 1972 which commenced before 1972.

1.019 Each rental building costing $50,000 or more will be placed in a separate capital cost allowance class where the building is acquired principally for the purpose of gaining or producing rental revenue. This new rule will apply to a rental building acquired after 1971 except where

(a) construction was commenced by the taxpayer before 1972, or

(b) construction was commenced pursuant to an agreement in writing entered into by the taxpayer before 1972.

1.020 Since this rule applies only where rental is the principal purpose, it will not be applicable, for example, to a factory or office building which is acquired principally for the purpose of gaining or producing income from an active business carried on by the taxpayer (other than a real estate rental business).

1.021 Reference should be made to the income tax regulations for complete details on the tax treatment outlined under this heading.

Interest on Money Borrowed to Purchase Shares

1.022 Under the Act, interest on money borrowed by a corporation to purchase shares of another corporation will be deductible after 1971. This includes interest on borrowed funds used to purchase shares of a non-resident corporation. The deduction is not restricted to funds borrowed after December 31, 1971, but may be claimed in respect of interest payable after December 31, 1971, on funds borrowed before that date.
20(1) (c), 248(1)

Example

Business Income		$525
Property Income		
Taxable Dividend on Share A	$120	
Deduct — Interest on money borrowed to purchase Share A	25	95
Net Income		620
Deduct — Taxable dividend on Share A		120
Taxable Income		$500

Restriction on Interest Deductible (Thin Capitalization)

1.023 The new Act imposes a restriction on the deduction of interest otherwise deductible that is paid by corporations resident in Canada to certain non-resident persons. This restriction has become known as the "thin capitalization" rule. The rule disallows the deduction of a portion of interest payable to specified non-residents, as defined in the Act, if the greatest amount of debt owing at any time in the year by the corporation to these specified non-residents exceeds three times the shareholders' total equity in the corporation at the commencement of the year. Transitional provisions permit an alleviation of this rule in the first taxation year commencing after 1971, and in the following year, for those corporations which were thinly capitalized at June 18, 1971. The specified non-residents are a non-resident shareholder or related shareholders owning 25% or more of the issued shares of any class of the corporation, or a non-resident (not a shareholder) who is related to any one of the above shareholders.
18(4), 18(5), 18(6), ITAR 22

Discount on Debt Obligations

1.024 The Act allows a deduction for all or one-half the amount of a discount paid in the year in respect of an interest-bearing obligation issued after June 18, 1971. If the obligation was issued at a discount of 3% or less, and the annual yield does not exceed 4/3 of the stated interest rate, the issuer may deduct the lesser of

(a) the amount by which the face value of the obligation exceeds the amount for which the obligation was issued, and

(b) the amount by which the amount paid in satisfaction of the face value exceeds the amount for which the obligation was issued.

20(1) (f)

1.025 If the obligation was issued at a discount greater than 3%, or if the annual yield exceeds 4/3 of the stated interest rate, then the amount deductible is one-half of the amount determined under (a) or (b) above, as the case may be.

1.026 Thus, if a corporation purchases its own bond on the open market at a price less than face value, but greater than the amount for which the bond was issued, the amount of the discount is limited to that which was actually paid, i.e., the difference between the purchase price and the amount for which the bond was issued. The discount is deductible when it is actually paid, either when the issuer redeems the obligation or when the issuer purchases the obligation for cancellation prior to the redemption date.

1.027 The following examples illustrate the method of calculating the amount of the discount deductible, assuming that all bonds were held to maturity and redeemed at face value:

	Case (1)	Case (2)	Case (3)
Face value of Bond	$100	$100	$100
Amount for which Bond issued	97	97	95
Discount	3%	3%	5%
Stated rate of interest	6%	5%	4%
Bond due in	1 year	5 years	2 years
Yield	9.27%	5.77%	6.84%

In Case (1), the yield (9.27% is greater than 4/3 the rate of interest (4/3 x 6% = 8%). Consequently, one-half the discount will be deductible.

In Case (2), the discount does not exceed 3% and the yield (5.77%) is not greater than 4/3 the rate of interest (4/3 x 5% = 6⅔%). Consequently, the entire discount will be deductible.

In Case (3), the discount exceeds 3%. Consequently, only one-half the discount will be deductible.

Carrying Charges on Vacant Land

1.028 Amounts paid or payable after 1971 on account of interest on borrowed money used to acquire vacant land, or interest on an amount payable for such land, or on account of property taxes in respect of that land (other than income or profits taxes or land transfer taxes), are deductible only to the extent that such interest and

taxes and all other carrying charges relating to the land do not exceed the gross revenue from the land. Any such interest or property taxes so disallowed may be added to the adjusted cost base of the land. This restriction on deductibility does not apply to

(a) land included in the inventory of the taxpayer's business,

(b) land held primarily for the purpose of gaining or producing income therefrom in the year,

(c) land on which a building is situated and land contiguous to a building that may reasonably be regarded as being used in connection with the building.

18(2), 18(3), 53(1) (h)

Foreign State Income Taxes

1.029 The Act introduces a deduction for foreign state income taxes in certain circumstances. If a Canadian corporation carrying on business in a foreign country pays an income or profits tax to the government of a state or other political subdivision of that country, the amount of tax so paid either may be deductible in computing world income subject to Canadian tax or may qualify as foreign tax credit. If, pursuant to the law of the foreign country, the state tax so paid is deductible in computing income on which the corporation will pay tax to the government of that country, and if the state tax is paid in respect of income from the business carried on in the foreign country, then the amount of the state tax paid will be deductible in computing world income subject to tax in Canada. If the state tax does not meet the above two qualifications, a credit will be allowed against the Canadian tax otherwise payable for the foreign state tax paid in respect of the business carried on in the foreign country. A discussion of foreign tax credits appears in Chapter 7.

20(12)

Interest on Income Bonds

1.030 Interest received from a corporation resident in Canada in respect of an income bond or debenture continues to be treated as a dividend in the hands of the recipient, unless the corporation paying the interest is entitled to deduct the interest. The Act also provides that interest on income bonds or debentures, which cannot be deducted in computing the income subject to tax in the paying corporation's country of residence will be deemed a dividend when received by the bondholder.

15(3), 18(1) (g), 248(1)

Inter-Corporate Dividends — Canadian Corporations

1.031 As in the past, inter-corporate dividends are initially included in the receiving corporation's income. The rules (which are similar to the rules under the old Act) for determining taxable income of the receiving corporation ordinarily allow such corporation to deduct the amount of dividends received from taxable Canadian corporations with the result that most inter-corporate dividends continue to pass tax-free through corporations.

112

Foreign Accrual Property Income

1.032 If a corporation resident in Canada either controls a non-resident corporation or has a substantial interest in the non-resident, the non-resident corporation may be considered to be a foreign affiliate of the resident corporation. Generally speaking, the Act requires that a shareholder's share of the foreign affiliate's property income be included in the Canadian corporation's income, whether or not it is actually remitted to Canada. For a discussion of foreign affiliates and foreign accrual property income, see Chapter 7.

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Taxable Capital Gains and Allowable Capital Losses

1.033 The new Act expands the definition of income to include one-half of capital gains (taxable capital gains) realized after 1971. One-half of capital losses (allowable capital losses) incurred after 1971 are deductible in computing net taxable capital gains. An analysis of the taxation of capital gains, including discussion of the new rules for determining the cost base of corporate property and shares, is contained in the Department of National Revenue's publication on capital gains. Accordingly, under this heading, only highlights of certain new rules peculiar to the taxation of corporate capital gains are mentioned.

3, 38, 39, ITAR 26

Valuation of Assets Held on December 31, 1971

1.034 Under the new Act an individual may value assets owned by him on December 31, 1971, either by utilizing the tax-free zone method or by electing the fair market value on "Valuation Day" to be the cost of all his assets. A corporation does not have such an election and must utilize the tax-free zone method to establish the cost of assets owned by it on December 31, 1971. Under the tax-free zone method, a capital gain is measured from the greater of the cost or valuation day value of an asset and a capital loss is measured from the lower of the cost or valuation day value of an asset. If the proceeds of disposition of a capital property are between the original cost and the valuation day value of the property,

there will be no taxable capital gain and no allowable capital loss.
ITAR 26(3), ITAR 26(7)

Capital Losses
1.035 The new Act permits a taxpayer to deduct one-half of capital losses (allowable capital losses) incurred in a year from one-half of capital gains (taxable capital gains) realized in the year. Should the allowable capital losses exceed the taxable capital gains the corporation is said to have a net capital loss which may be applied against capital gains already taxed in the prior year, and any excess may be carried forward to apply against capital gains which would otherwise be taxed in future years.
111

1.036 A corporation cannot carry over otherwise allowable capital losses if control of the corporation has changed.

1.037 A corporation cannot deduct a capital loss incurred on a disposition of property to

(a) a corporation controlled by it,

(b) a person by whom it was controlled, or

(c) a related corporation controlled by the same person by whom it is controlled.

85(4), 40(2) (e)

Dividend in Kind
1.038 Generally a taxable capital gain or an allowable capital loss will arise only when there has been a disposition of property. The new Act deems certain transactions or events to be dispositions. If a shareholder of a corporation receives property from the corporation as a dividend-in-kind (which is not a stock dividend) the shareholder is deemed to have acquired the property so received at a cost equal to its fair market value at that time, and the corporation is deemed to have disposed of the property at that time for proceeds equal to that fair market value. Consequently, payment of a dividend in kind may result in a corporation realizing a taxable capital gain.
52(2)

Foreign Exchange Capital Gains and Losses
1.039 Foreign exchange gains or losses on capital account are computed separately from other capital gains and losses. For individuals, the net gain or net loss is then reduced by $200 so that no such capital gain under $200 will be taxable and no such capital loss under $200 will be deductible. Foreign exchange capital gains or losses of corporations are not reduced by $200.
39(2)

Options
1.040 If a corporation grants an option pursuant to which the holder of the option may acquire shares, bonds or debentures to be issued by the corporation, the granting of the option does not give rise to any income tax implications. If the option is exercised, any consideration received for the granting of the option is added to the proceeds received for the issuing of the shares, bonds or debentures. If the option expires, the corporation is deemed to have disposed of capital property at the time of the expiry for proceeds equal to the consideration received for the granting of the option and the cost base of the capital property is deemed to be nil. Accordingly, the corporation realizes a capital gain in the year of expiry. The above rule differs from the taxation of other types of options.
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DETERMINATION OF TAXABLE INCOME

1.041 Certain amounts are deductible from net income to arrive at taxable income of a corporation for a taxation year. These amounts include charitable donations, all or part of losses sustained in other years, dividends received which are deductible under Section 112 and 113 of the Act, and foreign accrual tax on amounts that have been included in computing the net income of the corporation. The changes in the new Act in respect of these amounts are discussed below.

Charitable Donations
1.042 Two changes were made in this area which affect the deduction allowable for charitable donations made in a year. First, the maximum amount deductible is now 20% of net income as opposed to 10% previous to 1972. Secondly, gifts made to registered Canadian amateur athletic organizations, as defined, qualify as charitable donations.
110

Losses
1.043 Under the old Act, losses of other years were deductible from business income of a taxation year, but were restricted to business losses of those other years not already applied to reduce income from other sources in those other years. Under the new Act, all types of losses have been classified and the rules covering their deduction from net income have been changed. Losses are now classified as non-capital losses, net capital losses, and restricted farm losses, and all such losses are eligible

for some type of application against income of prior and subsequent years.
111

Non-Capital Loss

1.044 A non-capital loss of a corporation sustained in a taxation year means the amount by which

(i) the aggregate of all amounts each of which is a loss for the year from an office, employment, business or property, plus all dividends received which were deducted under Section 112 or 113 in computing taxable income for the year

exceeds

(ii) the aggregate of the incomes from business or property, plus the excess of taxable capital gains over allowable capital losses, less deductions allowed by subdivision (e) of division B which are not allocated to a source.

The inclusion of deductible dividends in (i) above means that if carrying charges in respect of taxable dividend income are in excess of other income, such excess will become a non-capital loss and be eligible for application against income in the prior year and the five subsequent years as illustrated in paragraph 1.048. Example 1 shows the determination of such a non-capital loss.

Example 1

Assume—	
Business income	$ 1,000
Dividend income	10,000
Total income	11,000
Less: Expenses related to dividends	2,000
Net income	9,000
Less: Deductible dividends	10,000
Taxable income	NIL
Non-Capital Loss Calculation	
Loss for year from business, property, office or employment plus dividends deducted	$10,000
Less: Net income	9,000
Non-capital loss	$ 1,000

To the extent that the corporation was unable to deduct expenses related to dividends from other income, a non-capital loss arises (expenses $2,000—business income of $1,000).

1.045 Non-capital losses incurred in a taxation year may be applied to reduce income in the immediately preceding taxation year and in the five subsequent taxation years. The income that is reduced by such losses is the net income of the corporation for the year after deducting charitable donations, restricted farm losses of other years, dividends received by the corporation which are deductible under Sections 112 and 113 of the Act, and the allowable deduction for tax on foreign accrual property income which is explained later.

1.046 All or part of a non-capital loss for a year may be applied (at the option of the taxpayer) to reduce the amount on which tax under Part IV of the Act would otherwise be calculated (Part IV tax is explained in detail in paragraphs 2.062 to 2.072). If non-capital losses are so applied, they are no longer deductible in computing taxable income in the previous year or in subsequent years. It is important to note that for the purpose of carrying a loss back one year and forward five years, it must first be applied to reduce other income under Part I in the year of the loss, and only the remaining loss may be used to reduce the amount to which Part IV tax is applied.

1.047 There are provisions in the Act whereby non-capital losses of preceding years are applied against a gain realized on a settlement of a debt. Where this is the case, that part of the non-capital losses so applied is no longer deductible in computing taxable income in a subsequent year.
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1.048 Example 2 shows the application of non-capital losses.

Example 2

(a Canadian-Controlled Private Corporation)

Assume—	Taxation Year		
	1972	1973	1974
Business income	$10,000	($18,000)	$ 6,000
Taxable dividends received from taxable Canadian corporations	3,000	2,800	2,500
Net income	13,000	NIL	8,500
Less:			
Deductible dividends	3,000	2,800	2,500
Taxable income (assuming no other deductions)	$10,000	NIL	$ 6,000

Determination of the Non-Capital Loss for 1973	
Loss from business	$18,000
Add: Dividends deducted from income pursuant to Section 112	2,800
Sub-total	20,800
Less:	
Net income (before deducting loss from business in the year)	2,800
Non-capital loss for 1973 taxation year	$18,000

Example 2 (cont'd)

Computation of Tax Payable for 1973

—Under Part I of the Act (no taxable income)		NIL
—Under Part IV of the Act		
Amount of taxable dividends received		$ 2,800
Less: Part of 1973 non-capital loss applied (at taxpayer's request)		2,800
Amount subject to Part IV tax		NIL

Revised Computation of Tax for 1972

—Under Part I of the Act		
Previous taxable income for the year		$10,000
Less: Part of 1973 non-capital loss		10,000
Revised taxable income for 1972		NIL
Part I tax payable		NIL
—Under Part IV of the Act		
Amount of taxable dividends received		$ 3,000
Less: Part of 1973 non-capital loss applied (at taxpayer's request)		3,000
Amount subject to Part IV tax		NIL

Computation of Tax Payable for 1974

Under Part I of the Act		
Taxable income for the year		$ 6,000
Less: Balance of unapplied non-capital loss for 1973 (see below)		2,200
Taxable income		$ 3,800
Tax 48%		$ 1,824
Less: Provincial Abatement 10%—	$380	
Small Business Deduction (23%)	$874	1,254
Part I tax payable		$ 570
Under Part IV of the Act		
Amount of taxable dividends received and subject to tax		$ 2,500
Part IV tax payable		$ 833

Application of 1973 non-capital loss of $18,000

1973—Part IV tax	$ 2,800
1972—Part IV tax	3,000
1972—Part I tax	10,000
1974—Part I tax	2,200
	$18,000

1.049 In the above example the company had the choice of applying part of the 1973 non-capital loss to reduce the amount subject to Part IV tax in 1972 and in 1973, or keeping it available to reduce taxable income in a subsequent year. This decision, of course, would be based on whether the company anticipated obtaining a refund of Part IV tax in the near future, and whether it expected to pay tax at the full corporate rate in the future (see paragraphs 2.068 and 2.069 on Part IV tax).

1.050 As mentioned earlier, any non-capital loss of another year must be applied against income in the computation of taxable income for the taxation year, and only a balance unapplied can be elected to reduce the amount subject to Part IV tax. Therefore, the balance of the unapplied non-capital loss of 1973 must, in 1974, be applied first against income in the computation of taxable income for 1974 before any remaining loss may be deducted from the amount subject to Part IV tax.

1.051 When a change in the control of a corporation occurs, there are rules to determine whether or not a corporation may use unapplied non-capital losses of prior years in the taxation year of the change of control and in subsequent taxation years. The rules are as follows:

(a) Where the control of a corporation has been acquired before the end of a taxation year by a person or persons who did not control the corporation at the end of the year in which a non-capital loss was sustained, that loss cannot be deducted from income of the taxation year and subsequent years unless the corporation is carrying on the same business in which the loss was sustained, regardless of any other business it might be carrying on.

(b) Where the control of a corporation is acquired before the end of a taxation year but after the winding up or discontinuance of a business, no part of a non-capital loss resulting from such discontinued business may be applied in the computation of taxable income for that or a subsequent year.

Transitional Rules, Non-Capital Losses and Business Losses

1.052 A business loss sustained in a taxation year ending prior to 1972, and not applied in a taxation year ending prior to 1972, will be deemed to have been a non-capital loss of that previous taxation year and will be deductible in the computation of taxable income of the 1972 and subsequent taxation years as a non-capital loss of a previous year.

1.053 Similarly a non-capital loss sustained in the 1972 taxation year shall be considered a business loss under the old Act and will be deductible in computing the taxpayer's taxable income for his 1971 taxation year. *ITAR 37*

1.054 Example 3 illustrates the transitional provisions pertaining to losses:

Example 3

Application of Losses Incurred Prior to 1972

	1969	1970	1971	1972	1973
Business income (loss)	$1,000	($10,000)	$4,000	$3,000	$5,000
Property income (interest)	500	800	1,200	900	850
Net income or (loss)	1,500	(9,200)	5,200	3,900	5,850
DEDUCT:					
1970 Business loss or non-capital loss applied	(1,000)	1,000			
		4,000	(4,000)		
		3,900		(3,900)	
		300			(300)
Taxable income	$ 500	NIL	$1,200	NIL	$5,550

Application of Losses incurred in 1972

	1971	1972
Business income (loss)	$5,000	($6,400)
Property income (interest)	1,000	
Net income	6,000	
DEDUCT: Deemed business loss for 1972	(5,000)	5,000
Taxable income	$1,000	
Balance of non-capital loss to be applied in future years		$1,400

Net Capital Loss

1.055 A net capital loss of a corporation incurred in a taxation year is the excess of

(a) its allowable capital losses for the year from dispositions of property (other than listed personal property)

over

(b) its taxable capital gains for the year from dispositions of property (other than listed personal property) and its taxable **net** gain from dispositions of listed personal property.
(Listed personal property is a special category of personal-use property. Since personal-use property is property used primarily for the personal use or enjoyment of a taxpayer or for the personal use or enjoyment of an individual related to the taxpayer, a corporation could own personal-use property and listed personal property.)

111, 54 (f)

1.056 In computing the taxable income for a taxation year, there may be deducted from the income for the year, the net capital losses for preceding taxation years, and for the immediately following taxation year, but only to the extent of the least of the following amounts:

(1) The balance of any unapplied portion of the net capital losses for preceding taxation years and the immediately following taxation year.

(2) The corporation's net income for the year less all applicable deductions except net capital losses.

(3) The taxable capital gain for the year from dispositions of property other than listed personal property, and its taxable net gains for the year from dispositions of listed personal property, minus the allowable capital losses for the year from dispositions of property other than listed personal property.

1.057 As illustrated below, a net capital loss does not reduce business or property income subject to tax.

Example 4

	1971	1972	1973	1974
Business income (loss)	$10,000	$12,000	($2,000)	$7,000
Taxable capital gain for the year	800[1]	1,000	3,500	1,200
Allowable capital loss for the year	—	$ 4,200	—	$ 500
Net taxable capital gain	800	—	3,500	700
Net capital loss for year	—	3,200[2]	—	—
Net income	10,000	12,000	1,500	7,700
DEDUCT:				
Net capital loss applicable	—	—	1,500	700
	$10,000	$12,000	NIL	$7,000

[1] This is not a "taxable capital gain" since it occurred prior to 1972, and is not income in 1971.

ITAR 26(1)

[2] Unlike a non-capital loss, a net capital loss sustained in a 1972 taxation year will not be reduced by applying any part of it to a taxation year ending before 1972.

ITAR 37(4)

1.058 Where control of a corporation is acquired before the end of a taxation year, the corporation cannot deduct in that year or a subsequent year any net capital losses sustained in taxation years preceding the taxation year in which control was acquired.

Restricted Farm Loss

1.059 A restricted farm loss of a corporation whose chief source of income is neither farming nor a combination of farming and some other source of income is the amount of a net loss in a taxation year from all farming operations which is not deductible in the taxation year.

1.060 For example, a corporation whose chief source of income is not farming, that sustained a $6,000 loss from farming in a taxation year will have sustained a restricted farm loss of $1,750 computed as follows:

Farming loss in year		$6,000
Deductible in year—	$2,500	
½(6,000 − 2,500)	1,750	
		4,250
Balance is restricted farm loss		$1,750

1.061 In computing the taxable income for a taxation year, there may be deducted from the income for the year, the restricted farm losses for the five immediately preceding taxation years and for the immediately following taxation year, but only to the extent of the least of the following amounts:

(1) The balance of the unapplied portion of the restricted farm losses for other taxation years.

(2) The corporation's income for the year from all farming businesses carried on by it.

(3) The corporation's net income for the year after deducting charitable donations, dividends received by the corporation which are deductible under Sections 112 and 113 of the Act, and tax on foreign accrual property income.

111(1) (c)

1.062 Provisions in the Act require a taxpayer on the sale of land used in a farming business carried on by the taxpayer to add, under certain conditions, his restricted farm loss to the adjusted cost base of the property. If such is the case, the amount available for deduction in computing taxable income for any year will be reduced by the amount added to the cost base.

53(1) (i)

1.063 A restricted farm loss may be applied to reduce the capital gain on sale of farmlands, and to the extent that it is used for this purpose it is no longer available to reduce income from farming.

111(7)

Loss Deduction Priority

1.064 Where in a taxation year more than one type of loss may be deducted in the computation of taxable income, the order of priority of the deduction is restricted farm losses, non-capital losses, and net capital losses. Examples 5 and 6 illustrate the priority of deduction.

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Example 5

	1972	1973	1974
Business income (loss)	($10,000)	($2,300)	$11,300
*Hobby farming income (total loss of $3,500 in 1972)	(3,000)	2,500	1,400
Allowable capital loss	—	(1,500)	—
Net taxable capital gains	—	—	1,000
Net income	NIL	200	13,700
DEDUCT:			
Restricted farm loss applicable		200	300
Non-capital loss applicable		—	13,000
Net capital loss applicable		—	400
		200	13,700
Taxable income		NIL	NIL

NOTES:

In example 5, since $400 of the net capital loss of $1,500 in 1973 was used in 1974, $1,100 of such loss is available for application to subsequent years.

*There is a hobby farming loss of $3,500 in 1972 of which $3,000 is allowable in 1972 leaving a restricted farm loss of $500 in 1972 to be applied against income in 1973 and 1974 ($3,500 − (2,500 + ½ of $1,000)). The allowable amount of $3,000 is added to non-capital losses in 1972 since there is no income in 1972 to absorb it.

Example 6

	1972	1973	1974
Business income (loss)	$7,000	$3,000	($4,500)
Allowable capital loss	(1,000)	—	—
Taxable capital gains	—	2,000	—
Net income (non-capital loss)	7,000	5,000	(4,500)
DEDUCT:			
Non-capital loss applicable	—	4,500	
Net capital loss applicable	—	500	
		5,000	
Taxable income	$7,000	NIL	

NOTE:

Originally, the 1973 taxable capital gain would be offset by the 1972 allowable capital loss. Because of the 1974 results, the 1973 return would be adjusted as shown above in accordance with the priority in the application of losses.

Dividends

1.065 Certain taxable dividends received that have to be included in income are deductible in computing taxable income. Dividends received by a corporation from another corporation that have to be included in income are called taxable dividends.

Dividends Received From a Corporation Resident in Canada

1.066 Taxable dividends received from a corporation resident in Canada are generally deductible if received from a taxable Canadian corporation, or from a corporation resident in Canada and controlled by the receiving corporation. One exception is where a corporation that

was a dealer in securities received a dividend paid out of the payer corporation's designated surplus.
112

1.067 A Canadian corporation is a corporation that, at the time the dividend was paid, was either a resident corporation incorporated in Canada, or a corporation resident in Canada throughout the period from June 18, 1971, until the time the dividend was paid. It is assumed throughout this discussion that such corporations are taxable, i.e., they are not exempt from tax under Part I for the taxation year during which the dividend was received by the other corporation. The rules for determining the residency of a corporation are discussed in paragraph 1.001.

1.068 Taxable dividends are not deductible if received from a non-controlled resident corporation which is incorporated outside Canada, and which became resident at any time after June 18, 1971, and before it paid the dividend. Taxable dividends received from a corporation incorporated in Canada prior to April 27, 1965, which became resident at any time after June 18, 1971, would be deductible provided that they were paid after the corporation effectively became resident in Canada.

Dividends Received from a Non-Resident Corporation
1.069 Dividends received from a non-resident corporation which continuously carried on business in Canada through a permanent establishment, since June 18, 1971, are usually deductible in part. The amount deductible is the proportion of the dividend that the paying corporation's taxable income earned in Canada for the immediately preceding year is of the whole of the amount that its taxable income for that year would have been if it had been resident in Canada throughout the year.
112(2)

Dividends Received from Foreign Affiliates
1.070 Section 113 of the Act provides for the deduction of all or part of dividends received from foreign affiliates.

Losses Reduced by Deductible Dividends
1.071 If a corporation incurs a loss in connection with shares owned by it and has received deductible dividends in respect of those shares, the amount of the loss will be reduced by the amount of those deductible dividends if

(a) the corporation owned the share less than 365 days before the loss was sustained, or

(b) the corporation, at the time the dividend was received, owned more than 5% of the issued shares of the corporation.

112(3)

These provisions apply as well to losses sustained by a trader or dealer in securities whether incorporated or not.
112(4)

1.072 The remarks in the above paragraph do not apply to the extent that the dividends were subject to Part VII tax (tax on dividends paid out of designated surplus).

Foreign Accrual Taxes on Foreign Accrual Property Income
1.073 The deduction allowed in computing taxable income with regard to the amount of foreign accrual property income which is included in the corporation's net income for the year is, generally speaking, the lesser of the amount so included in the net income and two times the foreign accrual tax applicable to that amount. The result is that any foreign accrual property income taxed at 50% in the foreign country will not be taxed in Canada.
113(3)

CALCULATION OF TAX

Calculation of Tax Under Part I of the Act
1.074 Prior to 1972, the general rate of income tax for corporations was 18% on the first $35,000 of taxable income and 47% on the remainder. There was also an Old Age Security tax of 3% which is now abolished. For 1972 and subsequent years, the general rates of tax for corporations are as follows:

	Rate of Tax
1972	50%
1973	49%
1974	48%
1975	47%
1976	46%

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1.075 At the time of preparation of this publication, the Minister of Finance had introduced a notice of ways and means motion to amend the Income Tax Act. This motion, which was introduced on October 14, 1971, stated:

> "That with respect to taxable income earned after June 30, 1971, and before January 1, 1973, the tax payable under Part I of the said Act for the 1972 and 1973 taxation years by every corporation liable to pay tax computed under section 123 or 143 of the said Act as it reads in its application to those years

be reduced by an amount equal to seven per cent of the amount by which

(a) the tax so computed, adjusted in the manner specified in the said measure to take into account any applicable refunds of tax permitted by Part I of the said Act as it so reads

exceeds

(b) the deductions by sections 125 and 130 of the said Act as it so reads."

Since the amendments to the Act had not been passed at the time of publication, the comments and examples which follow do not include the effect of this tax reduction.

1.076 For corporations whose taxation year straddles December 31, the effective general rate of income tax under Part I for the taxation year is determined by prorating the above rates for the appropriate two years on a daily basis as illustrated in the space provided on the corporation T2 tax return. For example, the following would be the calculation of the effective tax rate for a twelve month taxation year ending March 31, 1973 (275 days in 1972 and 90 days in 1973).

$\frac{275}{365}$ of 50% (1972 rate)...........	37.67%
$\frac{90}{365}$ of 49% (1973 rate)...........	12.08%
Effective tax rate for the whole 1973 taxation year..................	49.75%

The above calculation, of course, will always produce a rate of tax falling somewhere between the rates of tax applicable for the two years involved.
ITAR 52

1.077 Certain deductions in computing the tax under Part I of the old Act continue to be allowable under the new Act. The provincial tax abatement of 10% of taxable income earned in a province (other than the Northwest Territories or the Yukon Territory) is unchanged, and the same rules apply for determining taxable income earned in a province. The rules relating to deductions from Canadian tax for income taxes paid to foreign countries in respect of income from businesses carried on in foreign countries, or in respect of investment and non-business income from sources in foreign countries, have been modified and are described in Chapter 7. Where a corporation is a Canadian-controlled private corporation, the income tax otherwise payable under Part I of the new Act may be reduced by the small business deduction which has the effect of reducing the tax payable under Part I to a rate of 25% on specified amounts of income from a Canadian active business. Details of the small business deduction are given in paragraphs 2.020 to 2.039.
124(1), 126, 125(1)

1.078 For corporations with profits from mineral resources, a deduction will continue to be allowed in computing income in respect of provincial mining taxes paid on income from mining operations for taxation years ending on or before December 31, 1976. For taxation years ending after that date, the Part I tax will be reduced by an abatement in respect of such income. The computation of this abatement is described in Chapter 6. A corporation engaged in logging operations may deduct from tax the lesser of ⅔ of the logging tax paid to a province or 6⅔% of the corporation's income for the year from logging operations in a province. However, under the new Act the amounts otherwise deductible in respect of all provinces cannot exceed 6⅔% of the corporation's taxable income for the year.
20(1) (v), 124(2), 127

1.079 Information concerning the payment of Part I tax, interest, penalties and refunds may be found in Chapter 3.

Special Taxes (Parts II to XIV of the Act)

1.080 In addition to the Part I tax on income which is described above, there are a number of special taxes payable (some of which are refundable) under Parts II to XIV of the new Act. Most of these special taxes apply to corporations, but only in certain circumstances. A list of these special taxes which are discussed in this pamphlet, and references to the paragraphs where they are discussed, may be found in Chapter 3. Two of the more common special taxes, which did not exist under the old Act, are briefly described below.

1.081 Perhaps the special tax most frequently applicable is the Part IV tax payable by private corporations on certain dividends received, and refundable in certain circumstances when dividends are paid. This tax is sometimes referred to as the "topping-up tax". Part IV tax and the method of obtaining a refund of it are described in detail in paragraphs 2.062 to 2.072.

1.082 Another special tax payable by Canadian-controlled private corporations which have been allowed the small business deduction is the Part V tax. This tax is payable where income subject to the small business deduction has been invested in property not acquired for the purpose of earning income from an active business,

and it is ordinarily refundable when the corporation disposes of such investments or pays dividends to its shareholders. Details concerning this tax may be found in paragraphs 2.044 to 2.055.

Where 1972 Fiscal Period Straddles December 31, 1971

1.083 Where a corporation's 1972 fiscal year includes a period prior to January 1, 1972, special rules are provided for the calculation of Part I tax payable for that period. These rules, which are illustrated in Example I (Case 2) require:

(a) a calculation of the tax payable on net taxable capital gains earned and realized from January 1, 1972, to the end of the fiscal period,

(b) a calculation of the tax payable on taxable income, excluding capital gains, at 1972 rates of tax,

(c) a calculation of the tax payable on taxable income, excluding capital gains, at 1971 rates of tax,

(d) a proration of the calculation at 1972 rates to determine the proportion of that amount that the number of days in 1972 and in the taxation year is of the number of days in the taxation year,

(e) a proration of the calculation at 1971 rates to determine the proportion of that amount that the remaining number of days in the taxation year is of the number of days in the taxation year,

(f) a summation of the results in (a), (d), and (e).
ITAR 51

1.084 In the event that net taxable capital gains earned and realized from January 1, 1972, to the end of the fiscal year exceed the taxable income for the whole of the fiscal year (see Example 1 (Case 1) below), the special rules are not applicable and the tax is calculated under Part I of the new Act on the taxable income for the year as if all of the taxable income had been earned after January 1, 1972.

1.085 Example 1 illustrates the calculation of tax under Part I for corporations whose 1972 fiscal period includes part of the 1971 calendar year.

Example 1

Assume:

Fiscal year ending June 30, 1972

	Case 1	Case 2
Active business income	$12,000	$10,000
Net taxable capital gains	10,000	4,000
Net income	$22,000	$14,000
Less—1971 loss carry-forward	14,000	—
Taxable income	$ 8,000	$14,000

Tax Calculation (Case 1)*

Taxable income..............	$8,000		
Tax—50% of taxable income			$ 4,000
Less: Provincial abatement—10% of taxable income		$ 800	
Small business deduction—25% of taxable income		2,000	
			2,800
Part I tax for the year			$ 1,200

*Since the net taxable capital gains for the year exceed the taxable income for the year, the special rules under ITAR Section 51 are not applicable and tax must therefore be calculated under Part I of the new Act.

Tax Calculation (Case 2)**

(1) Tax on Capital Gain Under New Act			
Net taxable capital gains (as above).................	$ 4,000		
Tax—50% of net taxable capital gains		$2,000	
Less: Provincial abatement—10% of net taxable capital gains		400	
Part I tax on capital gains			(1) $1,600
(2) Tax on Business Income Under New Act			
Business income (as above)....	$10,000		
Tax—50% of business income		$5,000	
Less: Provincial abatement—10% of business income		$1,000	
Small business deduction—25% of business income		2,500	
		$3,500	
		$1,500	
Part I tax under the new Act for period after December 31, 1971—$\frac{(182 \times \$1,500)}{366}$			(2) 746
(3) Tax on Business Income Under Old Act			
Business income (as above)....	$10,000		
Tax—21% of business income		$2,100	
Less: Provincial abatement—10% of business income		1,000	
		$1,100	
Part I tax under the old Act for period before January 1, 1972 $\frac{(184 \times \$1,100)}{366}$			(3) 553
PART I TAX FOR THE YEAR			$2,899

**Since the taxable income for the year exceeds the net taxable capital gains for the year, the special rules under ITAR Section 51, are applicable.

DISTRIBUTION OF CORPORATE EARNINGS

GENERAL REMARKS

Distributions Under the Old Act

1.086 Under the old Act, the general rules concerning the distribution of corporate earnings were (1) dividends paid by a corporation were included in the incomes of shareholders, and (2) any remaining after-tax earnings (which were technically referred to as undistributed income on hand) had to be included in the income of shareholders by way of dividends or deemed dividends before a return of capital or other amounts (such as capital gains) could be returned to the shareholder tax-free.

1.087 An exception to this rule was that a corporation could elect to pay a tax of 15% on certain amounts of undistributed income on hand and thereby create tax-paid undistributed income. This tax-paid undistributed income could then be released tax-free to the shareholders, normally by way of a stock dividend, which by definition was not considered to be a dividend.

1.088 The old Act also provided that certain corporate distributions or transactions such as

(a) distributions on the winding-up, discontinuance or reorganization of the business,

(b) the acquisition, redemption, reduction, or conversion of the corporation's common shares, and

(c) the payment of stock dividends

could give rise to deemed dividends in the hands of shareholders to the extent that the corporation had undistributed income on hand, less any tax-paid undistributed income. In addition, the premium on redemption or acquisition of shares of a corporation (other than common shares) was subject to a special tax payable by the corporation.

Distributions Under the New Act

1.089 The general rule that dividends paid by a corporation are included in the income of shareholders has not been changed. However, stock dividends paid after 1971 are no longer excluded from the definition of a dividend.

1.090 The distribution or appropriation of a corporation's property through the winding-up, discontinuance or reorganization of the business continues to give rise to a deemed dividend with two important changes. Generally speaking, these changes are:

(a) such distributions are first considered to be a return of capital, and

(b) the excess of the distribution over the amount considered to be a return of capital is deemed to be a dividend in the hands of the shareholders (notwithstanding the make-up of the corporation's surplus).

1.091 These changes are discussed in further detail in Chapter 4. One of the results of these changes is that the concept of undistributed income is being phased out (except for purposes of designated surplus) and the concept of paid-up capital is being introduced.

1.092 Where a corporation acquires, redeems, or converts any of its own shares, special rules varying with the nature of the transaction will apply. The special tax payable under the old Act on premiums paid on the redemption or acquisition of preferred shares is being phased out. Under the new Act the general rule is that premiums paid on the redemption or acquisition of any of the corporation's shares are deemed to be dividends. If, however, the shares were purchased on the open market, a special tax is payable on the premium and the deemed dividend rule does not apply.

Additional details concerning such premiums may be found in Chapter 4.

Designated Surplus

1.093 Under the old Act, dividends paid out of designated surplus of a controlled corporation were not, like other dividends, deductible in computing taxable income of the recipient. In some special circumstances the payer corporation was subject to a tax of 15% or 20%. The new Act provides that dividends paid out of the designated surplus of a controlled corporation will be deductible in computing the taxable income of the recipient, but a special tax will be payable by the recipient or the payer depending on the circumstances. Details concerning designated surplus rules may be found in Chapter 4.

DIVIDENDS PAID OUT OF PRE-1972 SURPLUS

1.094 While the general rule concerning dividends paid by a corporation is that they must be included in the income of the shareholder, a Canadian corporation

may elect, in certain circumstances, to pay dividends which are not to be included in the incomes of its shareholders out of surplus (as defined for tax purposes) accumulated before 1972. This surplus is referred to in the new Act as

(a) tax-paid undistributed surplus on hand, and

(b) 1971 capital surplus on hand.

12(1) (j), 12(1) (k), 82, 90, 83

1.095 Generally speaking, a corporation's after-tax earnings accumulated from 1950 to 1971 (referred to in the Act as 1971 undistributed income on hand) may be converted to tax-paid undistributed surplus on hand upon the payment of a special 15% tax, and then the remaining 85% of such after-tax earnings may be distributed tax-free to its shareholders. After a corporation has converted all of its 1971 undistributed income on hand to tax-paid undistributed surplus on hand, any remaining pre-1972 surplus as recognized for tax purposes (referred to in the Act as 1971 capital surplus on hand) may be distributed tax-free to its shareholders.

196, 83(1)

1.096 The method of calculating a corporation's tax-paid undistributed surplus on hand ((a) above), and its 1971 capital surplus on hand ((b) above), along with details concerning the special 15% tax on 1971 undistributed income on hand are discussed below.

Tax-Paid Undistributed Surplus on Hand

1.097 In order to create tax-paid undistributed surplus on hand, a corporation must first calculate its 1971 undistributed income on hand as defined in Part IX of the new Act. Basically, a corporation's 1971 undistributed income on hand is its undistributed income on hand as calculated under the old Act for the period 1950 to 1971 inclusive, with adjustments for certain transactions occurring after the end of its 1971 taxation year, less any tax-paid undistributed income at the end of 1971 (a term defined in the old Act). Details concerning this calculation are given at paragraph 1.114. Once such a calculation has been made, the corporation may elect in the prescribed manner and in the prescribed form to pay a special 15% tax under Part IX of the new Act on all or part of its 1971 undistributed income on hand thereby creating tax paid undistributed surplus on hand equal to 85% of the amount so elected upon. Prescribed forms may be obtained at the District Taxation Office where the corporation income tax return is filed. An election to pay this special 15% tax is null and void unless the tax is paid at the time of the election.

89(1) (k), 196

1.098 A corporation's tax-paid undistributed surplus on hand is basically the aggregate of 85% of all amounts on which the corporation has elected to pay the above-mentioned 15% tax under Part IX, plus any tax-paid undistributed income (a term defined in the old Act) at the end of 1971, minus all dividends previously paid out of tax-paid undistributed surplus on hand. A detailed description of tax-paid undistributed surplus on hand as defined in the new Act is provided at paragraph 1.115.

1.099 Some points which should be noted concerning the calculation and distribution of tax-paid undistributed surplus on hand are:

(a) a corporation need not elect to pay the 15% tax on all of its 1971 undistributed income on hand at one time,

(b) the retained earnings of a corporation which were taxed under the personal corporation rules in the old Act were considered to be tax-paid undistributed income under the old Act and therefore form part of the corporation's tax-paid undistributed surplus on hand (to the extent they were not paid out to shareholders),

(c) once an election to pay a dividend out of tax-paid undistributed surplus on hand has been validly made, the election cannot be revoked,

(d) dividends paid out of a corporation's tax-paid undistributed surplus on hand will reduce the adjusted cost base of the recipient's shares for purposes of computing capital gains on eventual disposal of those shares, and

53(2) (a) (i)

(e) in circumstances where a dividend, or a part of one, elected to be paid out of tax-paid undistributed surplus on hand exceeds the balance of that account, the corporation is liable to pay a special tax under Part III of the Act equal to the amount of the excess (see paragraphs 1.110 to 1.112 for details concerning excessive elections).

83(1) (a), 184(1)

1971 Capital Surplus On Hand

1.100 Where all of a corporation's 1971 undistributed income on hand has been converted to tax-paid undistributed surplus on hand (as described above), the corporation may elect to pay a dividend to its shareholders out of its 1971 capital surplus on hand. A corporation's 1971 capital surplus on hand is basically all of its retained earnings including net capital gains (both calculated

on a tax basis), minus its undistributed income on hand as calculated under the old Act from 1950 to 1971. A detailed description of 1971 capital surplus on hand may be found at paragraph 1.117.
83(1) (b), 89(1) (l)

1.101 The computation of a corporation's 1971 capital surplus on hand requires a calculation of the underlying tax value of the net assets of the corporation which is referred to in the Act as the tax equity of the corporation. A detailed description of tax equity may be found at paragraph 1.116.
89(1) (h)

1.102 Some points which should be noted concerning the calculation and distribution of 1971 capital surplus on hand are:

(a) where a corporation has elected that a dividend be paid out of 1971 capital surplus on hand at a time when it has 1971 undistributed income on hand, the corporation will be subject to a special tax under Part III of the Act (see paragraphs 1.110 to 1.112 for details concerning excessive elections).
83(1) (b), 184(1)

(b) because a corporation's 1971 capital surplus on hand may change after December 31, 1971, as a result of a transaction after that date, it is important that a new calculation of 1971 capital surplus on hand be made each time an election is being contemplated by the corporation,

(c) once an election to pay a dividend out of 1971 capital surplus on hand has been validly made, the election cannot be revoked,

(d) dividends paid out of a corporation's 1971 capital surplus on hand will reduce the adjusted cost base of the recipient's shares for purposes of computing capital gains on eventual disposal of those shares, and
53(2) (a) (i)

(e) in circumstances where a dividend, or a part of one, elected to be paid out of 1971 capital surplus on hand, exceeds the balance of that account, the corporation is liable to pay a special tax under Part III of the Act equal to the amount of the excess (see paragraphs 1.110 to 1.112 for details concerning excessive elections).
184(1)

The Election Form
1.103 To establish that a dividend is deemed to be paid from one of the above surplus accounts and is not taxable, the corporation must file the prescribed election form on or before the earliest of

(a) the day the dividend becomes payable, or

(b) the first day on which any part of the dividend was paid.
83(1)

1.104 The form provides for the corporation to designate the extent by which tax-paid undistributed surplus on hand and 1971 capital surplus on hand are reduced by the particular dividend.

Reporting of Dividends
1.105 A corporation is not required to report dividends paid out of tax-paid undistributed surplus on hand or 1971 capital surplus on hand on a T5 summary or supplementaries. However, it will be important that corporations paying such dividends inform their shareholders that

(a) the dividend is not to be included in computing the shareholders' incomes, and

(b) the dividend reduces the adjusted cost base of the recipients' shares for purposes of calculating capital gains tax.

1.106 Where a corporation pays such dividends to a corporate shareholder, it will be important that the recipient corporation know to what extent the dividends reduce the paying corporation's

(a) tax-paid undistributed surplus on hand, and

(b) 1971 capital surplus on hand

in order that the recipient corporation may compute its tax-paid undistributed surplus on hand and 1971 capital surplus on hand.

Inter-Corporate Dividends
1.107 It may be seen from the complete definitions of tax-paid undistributed surplus on hand and 1971 capital surplus on hand (see paragraphs 1.115 and 1.117) that such surpluses may be transferred from one corporation to another and retain their nature in the recipient corporation. For example, assume that corporation A

pays a dividend to corporation B (its shareholder) as follows:

Tax-paid undistributed surplus on hand..	$ 510
1971 capital surplus on hand...........	630
Amount of dividend..................	$1,140

On receipt of the dividend, corporation B's tax-paid undistributed surplus on hand increases by $510 and its 1971 capital surplus on hand increases by $630.

Part IX Tax Refunds

1.108 If the circumstances in the above example are such that corporation B controlled corporation A throughout the period commencing at the end of 1971 and ending immediately after the dividend was paid, and corporation A had control-period earnings available for the payment of dividends at the end of its 1971 taxation year (see Chapter 4 for an explanation of control-period earnings), then corporation B may apply for a refund of the $90 special tax paid under Part IX by corporation A to create the $510 of tax-paid undistributed surplus on hand. Such applications for refund must be made by the recipient corporation within two years from the end of the calendar year in which the dividend was paid. In the above example, the effect of receiving a $90 refund of the Part IX tax paid by corporation A is to convert the $510 of tax-paid undistributed surplus on hand in corporation B (along with the $90 of tax refunded) back into 1971 undistributed income on hand. Example 1 illustrates the refund of Part IX tax which may be obtained in connection with dividends paid out of a controlled corporation's tax-paid undistributed surplus on hand.
196(2)

1.109 It should be noted that if, in the above example, corporation B (the controlling corporation) had no 1971 capital surplus on hand when the dividend was paid, then no refund of the Part IX tax could be received.

Example 1

Assume

—Corporation B owns all of the shares of corporation A

—Corporation A has made no previous distributions out of its tax-paid undistributed surplus on hand

—Corporation B has 1971 capital surplus on hand at the time the dividend is received.

Calculation of Refund to Corporation B

	Case 1	Case 2	Case 3
(a) Dividend paid by corporation A out of tax-paid undistributed surplus on hand	$510	$510	$510
(b) $^{85}/_{100}$ of control-period earnings of corporation A at end of its 1971 taxation year (assumed to be as shown)	$830	$340	Nil
Refund which may be claimed by corporation B ($^{15}/_{85}$ of lesser of (a) or (b))	$ 90	$ 60	Nil

Adjustment of Surpluses in Corporation B

	Case 1	Case 2	Case 3
Decrease tax-paid undistributed surplus on hand by $^{85}/_{15}$ of refund	$510	$340	Nil
Increase 1971 undistributed income on hand by $^{100}/_{15}$ of refund	$600	$400	Nil

Excessive Elections

1.110 Where a corporation elects to pay a tax-free dividend to its shareholders out of

(a) tax-paid undistributed surplus on hand, or

(b) 1971 capital surplus on hand, or

(c) tax-paid undistributed surplus on hand and 1971 capital surplus on hand,

and the amount specified in the election as being paid out of a particular account exceeds the balance in that account, then a special tax equal to the amount of the excess is payable under Part III of the Act.
184(1)

1.111 In addition, where a corporation elects to pay a dividend out of its 1971 capital surplus on hand at a time when it has 1971 undistributed income on hand, a special tax equal to the lesser of

(a) the amount specified in the election, and

(b) the balance of its 1971 undistributed income on hand, at that time,

is payable under Part III of the Act.

1.112 A shareholder receiving a dividend which, as the result of an election, is designated as being payable out of tax-paid undistributed surplus on hand or 1971 capital surplus on hand will

(a) omit that dividend from income for the year, and

(b) deduct the amount so received from the adjusted cost base of his shares.

83(1) (c), 53(2) (a) (i)

Definitions

1.113 Detailed descriptions of some of the more complex terms and expressions used in the Act relating to the distribution of corporate earnings follow.

1971 Undistributed Income On Hand

1.114 1971 undistributed income on hand is defined by the Act to be the aggregate of:

(a) the amount of the corporation's undistributed income on hand as calculated under the old Act for the taxation years 1950 to 1971 inclusive,

(b) amounts received by the corporation after its 1971 taxation year but before 1972, that were dividends received or deemed to have been received by it under the old Act, and

(c) an amount in respect of dividends received by the corporation after December 31, 1971, from a controlled corporation out of the corporation's tax-paid undistributed surplus on hand for which the corporation has claimed a refund of the 15% tax paid by the controlled corporation,

less:

(d) the corporation's tax-paid undistributed income at December 31, 1971, as computed under the old Act,

(e) dividends paid by the corporation after its 1971 taxation year but before January 1, 1972, and dividends deemed to have been received in that period by its shareholders that would have been deducted in computing the corporation's undistributed income on hand at the end of 1971, and

(f) all amounts on which the corporation has previously elected to pay tax under Part IX of the new Act.

196(4)

Tax-Paid Undistributed Surplus On Hand

1.115 Tax-paid undistributed surplus on hand is defined by the Act to be the aggregate of:

(a) the lesser of

(i) the tax-paid undistributed income of the corporation at December 31, 1971, as computed under the old Act, and

(ii) the 1971 undistributed income on hand of the corporation at January 1, 1972, before deducting tax-paid undistributed income (see paragraph 1:114),

(b) all amounts on which the corporation has previously elected to pay a tax of 15% under Part IX (minus all amounts of that tax), and

(c) all amounts of non-taxable dividends paid to the corporation from another corporation out of its tax-paid undistributed surplus on hand unless the receiving corporation, in a control situation, has applied for a refund,

less:

(d) all amounts paid by the corporation previously out of its tax-paid undistributed surplus on hand.

89(1) (k)

Tax Equity

1.116 Tax equity of a corporation at the end of its 1971 taxation year is defined by the Act to be the aggregate of:

(a) the undepreciated capital cost of depreciable property of each class owned by the corporation immediately after the end of its 1971 taxation year,

(b) the cost of depreciable property that is not included in a prescribed class (such as property used in earning income from farming or fishing) less capital cost allowances previously claimed in respect of such property,

(c) the cost of any capital property owned at the end of its 1971 taxation year less any amount in respect of the cost of such property deducted in computing the income of the corporation for any taxation year ending before 1972,

(d) the value of the corporation's inventory used in computing its income at the end of its 1971 taxation year,

(e) any debts owing to the corporation or any other right of the corporation to receive an amount

that was outstanding at the end of its 1971 taxation year (unless the corporation is on the cash basis of accounting for income) less such amounts that have been previously written off for tax purposes,

(f) the amount of any money of the corporation on hand at the end of its 1971 taxation year,

(g) the cost to the corporation of other property or expenditures that were not deductible in computing the corporation's income for its 1971 or a previous taxation year, but that would have been deductible in computing its income for its 1971 taxation year if the Act as it read in its application to that year had been read without reference to any restriction on the quantum of a deduction thereunder (for example — unclaimed exploration, prospecting and development expenses),

less:

(h) all debts and other similar obligations owing by a corporation at the end of its 1971 taxation year less any such debts which, if paid by the corporation in its 1972 taxation year, would have been deductible in computing its income for that year, and

(i) the amount of any reserves deducted in computing the corporation's income for its 1971 taxation year under the old Act.

89(1) (h)

1971 Capital Surplus On Hand

1.117 1971 capital surplus on hand is defined by the Act to be the aggregate of:

(a) the tax equity of the corporation at the end of its 1971 taxation year,

(b) gains realized after December 31, 1971, on capital property owned by the corporation at December 31, 1971, equal to the amount by which the lesser of the fair market value of the property on valuation day and the proceeds of disposition exceeds the actual cost of the property,

(c) gains realized before 1972 on capital property owned at the end of the corporation's 1971 taxation year, or acquired after the end of the corporation's 1971 taxation year, equal to the amount by which the proceeds of disposition of the property exceeds the actual cost of the property,

(d) dividends received after 1971 out of 1971 capital surplus on hand of another corporation,

(e) ½ of the amount, if any, by which the actual proceeds on the sale of goodwill and other nothings by a private corporation exceeds the deemed proceeds as calculated under the ITAR,

less:

(f) the corporation's paid-up capital at the end of its 1971 taxation year,

(g) the amount of the corporation's undistributed income on hand as calculated under the old Act for the taxation years 1950 to 1971 inclusive,

(h) losses realized after December 31, 1971, on capital property owned by the corporation at December 31, 1971, equal to the amount by which the actual cost of the property to the corporation exceeds the greater of the fair market value of the property on valuation day and the proceeds of disposition of the property,

(i) losses realized before 1972 on capital property owned at the end of the corporation's 1971 taxation year, or acquired after the end of the corporation's 1971 taxation year, equal to the amount by which the actual cost of the property exceeds the proceeds of disposition of the property, and

(j) all amounts paid previously as dividends out of the corporation's 1971 capital surplus on hand.

89(1) (l)

Example

1.118 The following example illustrates the calculation of

(a) tax-paid undistributed surplus on hand, and

(b) 1971 capital surplus on hand.

For purposes of this example the information given in the balance sheet as at December 31, 1971, and the statement of undistributed income on hand (1950 to 1971) is assumed.

A Company Limited
Balance Sheet
As At December 31, 1971

Assets

Current				
Cash				$ 12,000
Accounts receivable			$225,000	
less allowance for doubtful accounts			20,000	
				205,000
Inventory—at lower of cost and fair market value				184,000
Marketable securities—at cost				72,491
				473,491
Fixed				
Land—at cost				82,000
	Cost	Accumulated depreciation		
Buildings	$144,000	$ 82,500	$ 61,500	
Furnishings	42,320	16,384	25,936	
Equipment	12,462	6,125	6,337	
	$198,782	$105,009		93,773
				175,773
Other				
Investment in subsidiary—at cost less dividends received				23,275
Organization expenses—at nominal value				1
Trademark—at nominal value				1
Goodwill—at cost				25,000
				48,277
				$697,541

Liabilities

Current		
Bank Loan		$ 60,000
Accounts payable		178,251
Income taxes payable		2,415
		240,666
Deferred Income Taxes		22,000
		262,666

Shareholders' Equity

Capital stock		
Authorized:		
1000 shares with a par value of $100 each	$100,000	
Issued and fully paid: 20 shares	$ 2,000	
Retained earnings ("Surplus")	432,875	
		434,875
		$697,541

A Company Limited
Statement Of Undistributed Income On Hand
(as calculated under the old Act)
1950 to 1971

Summary

Incomes (less losses)—1950 to 1971		$339,650
Expenses not allowed as deduction in computing income—1950 to 1971		
Income taxes		
Federal	$ 34,820	
Provincial	29,750	
	$ 64,570	
Other	10,580	75,150
		264,500
Dividends paid—1950 to 1971		67,000
Undistributed Income on Hand—1950 to 1971		$197,500

Reconciliation To Retained Earnings ("Surplus")

Undistributed Income on Hand—1950 to 1971		$197,500
Add:		
"Surplus" at end of 1949	$253,733	
Excess of capital gains over capital losses	7,200	
Excess of capital cost allowance claimed over depreciation written	2,771	
Landscaping costs written off for tax purposes but included in cost of land	1,500	$265,204
		$462,704
Less:		
Excess of provision for taxes over taxes assessed	$ 16,830	
Dividends credited to investment account	12,000	
Trademark written down to nominal value	999	29,829
Retained Earnings ("Surplus") at December 31, 1971		$432,875

A Company Limited
Computation Of Tax-Paid Undistributed Surplus On Hand
As At September 20, 1972

Balance at December 31, 1971		$ Nil
Created by payment of tax on 1971 undistributed income on hand		
Amount elected on at September 20, 1972 (Note)	$197,500	
Less—15% tax	29,625	
		167,875
Tax-Paid Undistributed Surplus On Hand at September 20, 1972		$167,875

Note:

It is assumed that on September 20, 1972, the corporation elected to pay tax under Part IX of the Act on all of its 1971 undistributed income on hand immediately before that date which amounted to $197,500.

A Company Limited
Computation Of 1971 Capital Surplus On Hand
(And Tax Equity)
As At March 31, 1973

Net Assets per 1971 Balance Sheet		
Assets		$697,541
Liabilities		262,666
		$434,875
Add:		
Dividends from subsidiary deducted from cost of shares in subsidiary	$ 12,000	
Deferred income taxes	22,000	34,000
		$468,875
Deduct:		
Excess of book value of depreciable assets over their undepreciated capital cost:		
Book value	$ 93,773	
Undepreciated capital cost	91,002	
	2,771	
Cost of landscaping written off for tax purposes but included in cost of land	1,500	
Goodwill	25,000	
Organization expenses	1	
Trademark	1	29,273
Tax Equity—as at December 31, 1971		$439,602
Deduct:		
Paid-up capital	$ 2,000	
Undistributed income on hand (1950-1971)	197,500	199,500
1971 Capital Surplus On Hand (at beginning of 1972)		$240,102
Add:		
1971 portion of gain on sale of marketable security (proceeds $1,200, V-day value $900, cost $400)*		500
1971 Capital Surplus On Hand—as at March 31, 1973		$240,602

*Sale made after December 31, 1971, but before March 31, 1973.

Chapter 2

SPECIAL RULES APPLICABLE TO PRIVATE CORPORATIONS

PRIVATE CORPORATIONS

2.001 A new class of corporations called private corporations has been introduced into Canadian tax law after 1971. In broad terms, all resident corporations other than public corporations and subsidiaries of public corporations are private corporations. The importance of the income tax implications where a corporation is a private corporation, or a particular type of private corporation such as a Canadian-controlled private corporation, cannot be over-emphasized. The reader is therefore asked to pay particular attention to the exact term used when a corporation is described in the Act or in this publication.

2.002 This chapter will discuss a number of special taxes, and refunds of some of these taxes, which apply only to private corporations or a particular type of private corporation. In broad terms, the objectives of these special taxes are either to provide an incentive for small Canadian active businesses, or to tax investment income flowing through private corporations to their individual shareholders at rates approximately equivalent to those rates paid by individuals receiving similar investment income directly. The special taxes obviate the need for personal corporations as defined under the old Act.

2.003 It is assumed in this chapter that the corporation is taxable in Canada, that it is not exempt from tax under Part I of the Act.

2.004 The definitions of a private corporation, and a Canadian-controlled private corporation appear below.

Definition Of A Private Corporation

2.005 A private corporation is one which meets all of the following requirements:

(a) Resident in Canada

(b) Not a public corporation

(c) Not controlled directly or indirectly by one or more public corporations.

89(1) (f)

Canadian-Controlled Private Corporations

2.006 A Canadian-controlled private corporation is one which meets all of the following requirements:

(a) A private corporation

(b) A corporation that was at any time a resident corporation and was
  (i) incorporated in Canada
  or
  (ii) resident in Canada from June 18, 1971, to that time.

(c) Not controlled directly or indirectly by one or more non-resident persons

(d) Not controlled directly or indirectly by one or more public corporations, and

(e) Not controlled directly or indirectly by any combination of persons in (c) and (d) above.

125(6) (a), 89(1) (a)

2.007 When considering the above requirements it is necessary to also consider what is meant by the terms "public corporation" and "resident in Canada". These terms are discussed below.

Public Corporation

2.008 A public corporation is generally a resident corporation which has a class of shares listed on a prescribed Canadian Stock Exchange or which has elected or been designated by the Minister of National Revenue to be a public corporation, having complied with prescribed conditions regarding the number of its shareholders, dispersal of ownership of its shares, public trading of its shares, and size of corporation. A public corporation may elect, or be designated by the Minister of National Revenue, not to be a public corporation if certain prescribed conditions are met. The definition of a public corporation in the Act and Regulations should be reviewed when there are questions in this area.

89(1) (g)

2.009 It will be noted from the definitions of "private

corporations" and "public corporations" that corporations that are not public corporations, but are controlled directly or indirectly by one or more public corporations, are neither private corporations nor public corporations.

Resident in Canada

2.010 The general rule of law is that a corporation is resident in the country where its central management and control is located regardless of the country in which the corporation is created by law. Concerning corporations incorporated in Canada, the Act provides further rules covering their resident status, which are,

(a) if incorporated on or after April 27, 1965, the corporation is deemed to be resident in Canada throughout each year simply by being incorporated in Canada and regardless of any other factors,

(b) if incorporated on or before April 26, 1965, the corporation is deemed to be resident throughout a year if, in that year or in any one of the corporation's preceding taxation years that ended after April 26, 1965, it was factually resident in Canada according to the general rule of law (described above), or it carried on business in Canada.

250(4)

Existence of Private Corporation

2.011 The provisions covering private corporations sometimes refer to the calculation of amounts in taxation years commencing after the corporation last became a private corporation. It is therefore important to note that a corporation that was a private corporation at the commencement of its 1972 taxation year (which might commence in 1971 or January 1, 1972) shall be considered to have last become a private corporation at the end of its 1971 taxation year. If a private corporation was incorporated after 1971 it shall be considered to have last become a private corporation immediately before incorporation.

89(1) (f)

Transitional

2.012 Where a corporation had a fiscal period part of which was in 1971 and the balance of which was in 1972, and the corporation was throughout the 1972 portion of that fiscal period a (1) private corporation (2) a Canadian-controlled private corporation or (3) a public corporation, the corporation shall be deemed to have had that character throughout the entire fiscal period.

ITAR 50

2.013 It should be noted that this transitional provision is only applicable in the context of sections that call for a corporation to be a certain type of corporation "throughout the year".

ANALYSIS OF NET INCOME

2.014 Private corporations that have income other than from an active business carried on in Canada are required to file an analysis of net income with each corporation T2 tax return. One reason for this analysis is to determine the special taxes payable in a taxation year and the refund of some of them. Also, the analysis is required for Canadian-controlled private corporations to restrict the small business incentive to income from Canadian active businesses.

2.015 There are no definite rules for determining what constitutes income from an active business. It has been held in the Courts that an adventure in the nature of a trade does not, in itself, constitute the carrying on of an active business. Also, whether or not rental operations constitute an active business will depend on the nature of the particular operation and consideration of the services provided to tenants.

Analysis

2.016 The items of net income that should be shown on the analysis are listed below. The amount of each item of income should be determined net of all relevant outlays and expenses which can be reasonably allocated to that item.

Analysis of Income

Canadian investment income
(Provide details described in paragraph 2.017)

Foreign investment income
(Provide details described in paragraph 2.018)

Dividends received that are deductible in
computing taxable income less relevant expenses

Net income from active business carried
on in Canada

Net income from foreign business

Subtotal

Less: Expenses not allocated to a source

Net income for tax purposes

Canadian Investment Income

2.017 Canadian investment income of a corporation for a taxation year is such income (and losses) from Canadian sources only, and includes the aggregate of

(a) the excess, if any, of taxable capital gains over allowable capital losses for the year

(b) income from property for the year except exempt income, and except dividends that are included in income but are deductible in computing taxable income

(c) income from non-active businesses

less the aggregate of all non-active business losses and property losses for the year.
129(4) (a)

Foreign Investment Income
2.018 Foreign investment income of a corporation for a taxation year is calculated by following the same procedure as outlined in the above paragraph, but in respect of income (and losses) from foreign sources only. The dividends "included in income but deductible in computing taxable income" are those dividends which so qualify which are received from foreign affiliates.
129(4) (b)

2.019 The importance of the determination of what is defined as Canadian or foreign investment income and the isolation of certain dividends received will be evident later.

SMALL BUSINESS DEDUCTION

General Remarks and Computation of the Deduction
2.020 The small business deduction can be defined as a credit against corporate tax otherwise payable on active Canadian business income and is designed as an incentive to small Canadian corporations. This credit is available only to corporations which qualify as Canadian-controlled private corporations during the whole taxation year. The definition of a Canadian-controlled private corporation was discussed in paragraph 2.006.
125

2.021 The credit takes the form of a deduction from tax for 1972 of 25% on a maximum of $50,000 of active Canadian business income. This percentage is reduced by one percentage point for each of the years 1973 to 1976 corresponding to the reduction in the general corporate tax rate with the result that, generally, the first $50,000 of active Canadian business income is subject to a net federal corporate tax rate of 25% before provincial tax abatement. The amount of $50,000 is called the corporation's "business limit" for a taxation year.

2.022 As a general rule, the corporation ceases to be eligible for the small business deduction when it has accumulated after 1971 $400,000 of taxable income attributable to active business. The amount of $400,000 is called the corporation's "total business limit" for a taxation year.

2.023 There is no general rule as to what constitutes active business income. This question must be decided on the basis of the facts in each case—see paragraph 2.015.

2.024 Where two or more corporations are associated, the annual business limit of $50,000 and the total business limit of $400,000 must be allocated among them—see paragraphs 2.037 to 2.039.

2.025 By way of a special tax under Part V of the Act, some or all of the small business deduction is recaptured when income which was eligible for the small business deduction is invested in non-business assets. This special tax is refundable when the non-business assets are disposed of and the funds reinvested in business assets or distributed as dividends. The provisions of Part V are discussed later in paragraphs 2.044 to 2.055.

2.026 For administrative simplicity the corporation T2 tax return outlines and explains the steps necessary to calculate the small business deduction for most cases. The comments in paragraphs 2.027 to 2.034 below are a further explanation of these steps, with examples, and in particular explain and illustrate the calculation of the small business deduction where a corporation is in receipt of foreign source income in a year.

Computation of Small Business Deduction
2.027 Because many corporations have income from sources other than active Canadian businesses, a formula is provided to ensure that the small business deduction applies to only Canadian active business income. Under this formula, the credit is determined by applying the applicable rate for the year (25% for 1972 reduced to 21% by 1976) on the least of the amounts determined by making the calculations described in (a) to (d) below: (see paragraph 2.028 for further comments).

(a) income less losses for the year from active businesses carried on by the corporation in Canada,

(b) taxable income for the year less the aggregate of:
 (i) $^{10}/_{4}$ths of the foreign tax credit deductible for the year on foreign investment income, and
 (ii) 2 times the foreign tax credit deductible for the year on foreign business income,

(c) the corporation's business limit for the year,

(d) the corporation's total business limit for the year less its cumulative deduction account at the end of the preceding taxation year.

2.028 Comments on items (a) to (d) above are as follows:

(a) This calculation determines the net income from Canadian active businesses.

(b) This determines the excess of taxable income over foreign source income, the amount of the latter being notionally determined by reference to the foreign tax credits allowed under Section 126.

(c) The business limit is generally $50,000.

(d) The total business limit is $400,000. The amount remaining eligible for the small business deduction in a year is obtained by deducting from $400,000 the balance in the cumulative deduction account at the end of the preceding year. See paragraphs 2.030 to 2.034.

2.029 Examples 1 and 2 illustrate the effect of the above formula. For the purpose of these examples, item (d) of the formula dealing with the total business limit of $400,000 and the cumulative deduction account should be ignored since the cumulative deduction account will be discussed later.

Example 1 — No income from foreign sources

	Case I	Case II
Assume the following calculation of taxable income—		
Net income from Canadian active business	$40,000	$40,000
Canadian investment income	6,000	—
	46,000	40,000
Charitable donations	2,000	2,000
Taxable income	$44,000	$38,000
Business limit for the year	$50,000	$50,000
Amount eligible for small business deduction— the least of (a), (b) or (c) in paragraph 2.027 above which is (a), the business income for Case I; and (b), the taxable income for Case II	$40,000	$38,000
Small business deduction, 25% for 1972	$10,000	$ 9,500

Example 2—Corporation has income from foreign sources

Assume the following calculation of taxable income—		
Net income from Canadian active business		$40,000
Foreign source investment income (deductible foreign tax credit of $600)		4,000
Foreign source business income (deductible foreign tax credit of $2,500)		7,000
		51,000
Non-capital loss of prior year		9,000
Taxable income		$42,000
Amount eligible for small business deduction— The least of (a), (b) or (c) in paragraph 2.027 above which is (b), the taxable income, with adjustments for foreign tax credits, calculated as follows:		
Taxable income		$42,000
Less (i) $^{10}/_{4}$ths of $600	$1,500	
(ii) 2 times $2,500	5,000	6,500
Amount eligible		$35,500
Small business deduction of 25% for 1972		$ 8,875

Cumulative Deduction Account

2.030 The computation of the cumulative deduction account is described in paragraph 2.034. To understand its purpose it is helpful to regard it as simply an accumulation of taxable incomes attributable to an active business reduced by $^4/_3$ of taxable dividends paid. In application it is deducted from the total business limit of $400,000 to determine the amount remaining eligible for a small business deduction. Its purpose therefore is to restrict the total small business deduction that may be obtained by any corporation, and to reduce the total small business deduction available for highly profitable corporations. *125(6) (b)*

2.031 The accumulation of taxable business incomes is reduced by $^4/_3$ of dividends paid which represents that income distributed to shareholders and taxed in their hands. Small corporations may be able to remain eligible for the small business deduction for an indefinite period by paying dividends that keep the cumulative deduction account under $400,000. However corporations that have income taxed at the full corporate rate will find the cumulative deduction account increases even if all after-tax income is paid out by dividends.

2.032 The following example 3 illustrates how the small business deduction is calculated over a period of years.

Example (3)

Assume	1972	1973	1974	1975	1976
Canadian business income (taxable income)	$50,000	$325,000	$225,000	$200,000	$250,000
Dividends paid			90,000	300,000	
Computation of cumulative deduction account					
Taxable incomes	$50,000	$375,000	$600,000	$800,000	$1,050,000
Deduct $^4/_3$rds of dividends paid			$120,000	$520,000	$520,000
Cumulative deduction account	$50,000	$375,000	$480,000	$280,000	$530,000

Example 3 (cont'd)

Calculation of small business deduction

	1972	1973	1974	1975	1976
Determine the lesser of—					
(a) Net active Canadian business	$ 50,000	$325,000	$225,000	$200,000	$250,000
(b) Taxable income for year	$ 50,000	$325,000	$225,000	$200,000	$250,000
(c) Business limit	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000
(d) Total business limit	$400,000	$400,000	$400,000	$400,000	$400,000
Less cumulative deduction account of preceding year (above)	—	50,000	375,000	480,000	280,000
	$400,000	$350,000	$ 25,000	NIL	$120,000
Small business deduction					
The lesser of (a), (b), (c) and (d) is	50,000	50,000	25,000	NIL	50,000
Applicable rate of small business deduction	25%	24%	23%	22%	21%
Small business deduction for the year	$ 12,500	$ 12,000	$ 5,750	NIL	$ 10,500

2.033 The following example 4 illustrates the effect of the payment of a taxable dividend on the cumulative deduction account where income was subject to the full corporate rate of tax.

Example 4

Assume	
Taxation year ends on December 31, 1972	
Taxable income (all from Canadian active business)	$1,050,000
Computation of net profit after tax	
Part I tax (50%)	$ 525,000
Deduct: Small business deduction	12,500
Tax payable (ignoring provincial implications)	$ 512,500
Net profit after taxes assumed paid as dividend	$ 537,500
Computation of cumulative deduction account	
Taxable income	$1,050,000
Deduct: $^4/_3$ of taxable dividend paid	716,667
Cumulative deduction account December 31, 1972	$ 333,333

Note that despite the distribution of all after-tax income the cumulative deduction account has a balance equal to $^1/_3$ of the income that was taxed at the full corporate rate.

2.034 Much of the complexity in the computation of the cumulative deduction account results from the adjustments necessary to ensure that investment income is removed from the account. The actual method of calculation at the end of a taxation year is as follows:

the aggregate of

(a) its taxable incomes for taxation years commencing after December 31, 1971, and ending not later than the end of the particular taxation year, and

(b) $^4/_3$ of dividends received by the corporation which are deductible from income under Section 112 or subsection 113(1) of the Act in computing the corporation's taxable incomes for those years (this provision adds to the cumulative deduction account an amount equal to the deduction which will be effected on distribution). (See (c) below.)

less the aggregate of

(c) $^4/_3$ of the taxable dividends paid by the corporation for those years (this is the amount which is included in the income of the individual shareholder), and

(d) 4 times the excess of the refundable dividend tax on hand at the end of the year over the dividend refund for the year (this removes any income in (a) and (b) above which is not from an active business—see paragraphs 2.079 to 2.086 which describe the calculation of refundable dividend tax on hand).

2.035 Example 5 illustrates the calculation of the cumulative deduction account for the 1972 taxation year.

Example 5 (a)

Assume	
Business income	$30,000
Investment income	2,000
Dividends received	3,000
Cumulative deduction account	
Taxable income	$32,000
$^4/_3$rds of dividends received	4,000
	36,000
Deduct:	
4 times refundable dividend tax on hand minus the dividend refund for the year (see below)	6,000
Cumulative deduction account at the end of the 1972 taxation year	$30,000
Refundable dividend tax on hand	
25% of investment income	$ 500
33⅓% of dividends received (Part IV tax)	1,000
Refundable dividend tax on hand (dividend refund for the year is NIL)	$ 1,500

For explanation of computation of refundable dividend tax on hand see paragraphs 2.079 to 2.086.

2.036 Example 5(a) illustrates that as a result of multiplying the refundable dividend tax on hand by 4, the dividends and investment income are removed from the cumulative deduction account and all that remains is the active business income. Example 5(b) illustrates a similar result when the corporation pays a dividend in the year.

Example 5 (b)

Assume		
Dividends paid		$ 3,000
Other facts as in (a) above		
Cumulative deduction account		
Taxable income		$32,000
4/3rds of dividends received		4,000
		36,000
Deduct:		
4/3rds of dividends paid	$4,000	
4 times refundable dividend tax on hand minus the dividend refund for the year (see below)	2,000	6,000
Cumulative deduction account at the end of the 1972 taxation year		30,000
Refundable dividend tax on hand		
25% of investment income received		$ 500
33⅓% of dividends received (Part IV tax)		1,000
Refundable dividend tax on hand		1,500
Deduct: ⅓ of dividends paid in the year		1,000
Refundable dividend tax on hand minus the dividend refund		$ 500

For explanation of the dividend refund see paragraphs 2.095 to 2.099.

Associated Corporations

2.037 The Act provides that where two or more companies are associated, each corporation will not have a business limit of $50,000 and a total business limit of $400,000, but rather the group as a whole will have a business limit of $50,000 and a total business limit of $400,000. The group's business limit and total business limit may be allocated among the corporations in the group in any manner they wish by filing an annual election in prescribed form, provided that the portion of the total business limit allocated to a specific corporation is not less than that corporation's cumulative deduction account at the end of the previous year as illustrated by example 6.

Example 6

	Corporation A	Corporation B
Assume		
Active business income and taxable income for year	$ 60,000	$ 15,000
Cumulative deduction account at end of preceding year	$200,000	$ 50,000
Allocation of business limit by corporation	$ 35,000	$ 15,000

Example 6 (cont'd)

The $50,000 business limit can be allocated in any proportion desired but it would not be reasonable to allocate more than $15,000 to corporation B		
Allocation of total business limit		
The $400,000 total business limit must be allocated so that at least $200,000 is allocated to Company A and $50,000 to Company B—		
assume allocated as	$300,000	$100,000
The small business deduction will be based on the least of—		
(a) Business limit for year above	$ 35,000	$ 15,000
(b) Total business limit as above	$300,000	$100,000
Less cumulative deduction account —previous year	200,000	50,000
	$100,000	$ 50,000

2.038 If two or more corporations become associated after 1971 at a time when the aggregate of their cumulative deduction accounts exceeds $400,000, there is no requirement for the associated group to refund any of the small business deduction received on the excess of $400,000. Of course, no further small business deduction will be available to the group unless the aggregate of their cumulative deduction accounts is reduced below $400,000 by payment of dividends.

2.039 The agreement to allocate the business limit and the total business limit among associated corporations should be filed with the District Taxation Office where the first corporation in the group files its return for a taxation year.

Corporations Having Taxation Years Other Than Calendar Years

2.040 Where a corporation has a taxation year which does not coincide with the calendar year, there are two special transitional provisions as described below.

2.041 One transitional provision has the effect of limiting the small business deduction in 1972 taxation years which began in 1971. By computing tax payable for the year in three steps, only one of which includes the small business deduction, and prorating the result of that one according to the number of days in the taxation year in 1972, the small business deduction for the year is reduced. An example of the application of this rule is contained in paragraph 1.085 of this pamphlet.
ITAR 51(1)

2.042 Another transitional provision applies where taxation years ending in 1973 to 1976 inclusive do not coincide with the calendar year. This provision is required because the rate of the small business deduction reduces by one percentage point for each of the years 1973 to

1976. Where a taxation year straddles December 31, the rates of tax for the two calendar years involved are prorated on a daily basis to produce the effective rate of tax for the year along the same lines as illustrated in paragraph 1.076 in respect of the general corporate rates. For convenience, the effective rate for the small business deduction may be determined by deducting 25 percentage points from that general corporate rate, as follows:
ITAR 50(4)

Assume

1973 taxation year ends March 31, 1973	
Part I tax rate (see paragraph 1.076)	49.75%
Deduct	25.00%
Applicable rate for small business deduction	24.75%

2.043 A space will be provided on the corporate T2 tax return when required for making this calculation.

PART V — REFUNDABLE TAX IN RESPECT OF INELIGIBLE INVESTMENTS

Purpose of Part V Tax

2.044 One objective of the small business deduction is to provide corporations with funds for use in their active business by reducing the amount of tax payable. This objective is significant in discussing the tax in respect of ineligible investments. Investment in an asset of this type indicates income is not being used in the active business, and a special tax under Part V of the Act is levied to recapture the small business deduction allowed.
188, 189

Liability for Part V Tax

2.045 A corporation that was a Canadian-controlled private corporation at any time in a taxation year would be liable to pay Part V tax in respect of ineligible investments acquired after 1971. The tax, however, is not to be levied on an amount greater than the income on which the corporation has been allowed the small business deduction. This amount is called the preferred-rate amount and it is described in paragraph 2.049. Since the tax is related to the cost of ineligible investments or the preferred-rate amount, the source of the funds actually used to make the investments is not relevant.

2.046 A corporation that was a Canadian-controlled private corporation throughout a taxation year would be entitled to a refund of Part V tax previously paid if it disposed of ineligible investments.

2.047 Ineligible investments can be described as investments acquired after 1971 which are property not acquired for the purpose of earning income from an active business. However, cash on deposit, short-term debt securities, and short-term government or similar bonds do not come under the definition of ineligible investments. Shares and debt obligations of a controlled private corporation are not normally ineligible investments but there are certain exceptions where the controlled corporation itself has ineligible investments. The definition of "ineligible investments" appears in Section 189(4)(b) of the amended Act which should be referred to if the classification of an investment is in doubt. In general, the most common ineligible investments are shares in public or non-resident corporations, shares in private corporations which do not constitute control, long-term debt securities, and rental property where such property does not constitute all or part of an active business.

2.048 For administrative simplicity, the corporation T2 tax return will outline and explain the steps necessary to calculate Part V tax payable and refundable, if any. The comments in paragraphs 2.049 to 2.055 below are a further explanation of these steps, with examples.

Preferred-rate Amount

2.049 As previously stated, Part V tax is not to be levied on an amount greater than the income on which the corporation has been allowed the small business deduction, and that amount is to be reduced by such income distributed to shareholders and taxed in their hands. The preferred-rate amount is a calculation of the appropriate amount. It is computed as follows:

The aggregate of

(a) its preferred-rate amount, if any, at the end of the preceding taxation year,

(b) 4 times its small business deduction for the year,

(c) $^4/_3$ of taxable dividends received by the corporation in the year and after 1971 from another corporation controlled directly or indirectly by it to the extent that the dividends
  (i) reduced the payer corporation's preferred-rate amount, and
  (ii) were not subject to Part VII tax on designated surplus

Less the aggregate of—

(d) $^4/_3$ of the amount, if any, by which taxable dividends paid by the corporation in the year, and after 1971, exceeds 3 times its dividend refund for that year, and

(e) amounts on which Part VI tax has become payable in the year.

189(4) (c)

When a corporation is computing its preferred-rate amount at the end of its 1972 taxation year and such taxation year straddles December 31, 1971, the amount of the small business deduction to be included is the proportion of the amount otherwise determined that the number of days in the taxation year that are in 1972 is of the number of days in the whole taxation year.
ITAR 64

2.050 The following are comments on items (a) to (e) in the above formula:

(a) Item (a) is simply the balance forward from the preceding year.

(b) Item (b) includes in the preferred-rate amount 4 times the small business deduction which in 1972 equals the income on which the deduction was computed. In subsequent years, the small business deduction rate is less than 25% and the amount included in the preferred-rate amount will accordingly be less than the full amount of income on which the deduction was computed. However, since the Part V tax rate is 25%, the tax on 4 times the small business deduction will equal the deduction regardless of the rate.

(c) Item (c) provides for a transfer from the preferred-rate amount of the subsidiary to that of the parent when the subsidiary pays a dividend to the parent. The amount transferred is discussed in (d) below.

(d) Item (d) reduces the preferred-rate amount by the amount of income on which a small business deduction has been allowed that has been distributed to shareholders and taxed in their hands. That amount of income is equal to $^4/_3$ of dividends paid from active business income. A dividend is considered paid from active business income to the extent it exceeds 3 times the dividend refund for the year. The deduction in respect of dividends paid cannot exceed the preferred-rate amount at the time the dividend was paid.

(e) Item (e) refers to an amount which becomes subject to Part VI tax when a Canadian-controlled private corporation becomes a non-Canadian-controlled private corporation, a subject which is discussed in paragraphs 2.056 to 2.061.

Calculation of Part V Tax

2.051 The part V tax at the end of a taxation year is calculated as follows:

The tax is 25% of the lesser of

(a) 2 times the cost of ineligible investments acquired after 1971 and owned at the end of the year, and

(b) the corporation's preferred-rate amount at the end of the year determined in accordance with the formula described above.

2.052 The Part V tax payable for the year is the Part V tax determined above minus the balance of Part V tax of the corporation at the end of the preceding taxation year. The balance of Part V tax at the end of the preceding year is the excess of Part V tax payable for previous taxation years over Part V tax refundable for previous taxation years.

Calculation of Refund of Part V Tax

2.053 If the balance of the cumulative Part V tax at the end of the previous year exceeds 25% of the lesser of (a) and (b) above, the corporation is entitled to a refund of Part V tax previously paid to the extent of such excess.
189(4) (d)

2.054 Examples of Part V tax payable and refundable appear below.

Example 1

	1972	1973	1974
Assume—			
Business earnings	$20,000	$25,000	$ 40,000
Small business deduction	5,000(25%)	6,000(24%)	9,200(23%)
Ineligible investments	8,000	—	100,000
—Preferred rate amount—			
At end of preceding year	—	$20,000	$ 44,000
4 times small business deduction in taxation year	$20,000	$24,000	$ 36,800
Preferred-rate amount at end of year	20,000	44,000	80,800
—Part V Tax Payable in Year			
2 times ineligible investments	$16,000	—	$200,000
Preferred-rate amount	20,000	44,000	80,800
25% tax on lesser of above	4,000	—	20,200
Less cumulative Part V tax at end of previous year (see below)	—	4,000	NIL
Tax payable (refund)	$ 4,000	$(4,000)	$ 20,200

Example 1 (cont'd)

	1972	1973	1974
—Cumulative Part V Tax			
Balance from preceding year	—	$4,000	—
Add Part V tax payable	$4,000		$20,200
Deduct Part V tax refund	—	4,000	—
Balance at end of year	$4,000	NIL	$20,200

NOTE

Because of the substantial ineligible investment in 1974, the total of $20,200 small business deduction for the three years is recaptured. The 1974 example illustrates the limiting of the tax to 25% of the preferred-rate amount where ineligible investments exceed the income of the corporation subject to the small business deduction.

Example 2 of Part V Tax Payable

To illustrate the effect of paying a dividend which did not result in a dividend refund (see paragraphs 2.095 to 2.099), assume that a dividend was paid in 1974 of $30,000 in addition to the assumptions above.

	1974
—Preferred-rate amount as above	$ 80,800
Deduct $^4/_3$ of $30,000 dividend paid	40,000
Revised preferred-rate amount	$ 40,800
—Part V Tax Payable in year	
2 × ineligible investments	200,000
Preferred-rate amount	40,800
25% tax on lesser of above	10,200
Less cumulative Part V tax at end of previous year	NIL
Tax payable	$ 10,200

Payment of Tax and Prescribed Return

2.055 Part V tax is payable on or before the last day of the third month after the end of the taxation year. If there is a refund, it may be applied against any other liability for tax under the Act.

The prescribed return for Part V tax is the T2 corporation income tax return. Chapter 3 discusses payments, instalment payments, overpayments, interest, and penalties in respect of all taxes imposed by the amended Act.

PART VI TAX WHEN A CORPORATION BECOMES A NON-CANADIAN-CONTROLLED PRIVATE CORPORATION

Purpose of Part VI Tax

2.056 As indicated earlier, the small business deduction is available only to Canadian-controlled private corporations. Where such a corporation becomes a private corporation other than a Canadian-controlled private corporation, generally as a result of control of the corporation having been acquired by non-residents, a tax under Part VI may be payable to recapture the small business deductions allowed the corporation.
190, 191

Liability for Part VI Tax

2.057 The tax payable under Part VI is 25% of the excess of the preferred-rate amount at the time the corporation becomes a non-Canadian-controlled private corporation over 4 times the balance of Part V tax at the end of the preceding taxation year. The preferred-rate amount was described in paragraphs 2.049 to 2.050. The purpose of the adjustment for the Part V tax is to allow for the recovery of the small business deduction already made because the corporation had ineligible investments.

2.058 It will be noted that in computing the preferred-rate amount for the purposes of Part V tax, there is a provision to reduce the preferred-rate amount by amounts upon which Part VI tax is payable. As a result no Part V tax will become payable for a year when Part VI tax was exigible.

2.059 Part VI tax is payable in five equal annual instalments with the first instalment due at the time when the corporation T2 tax return is required to be filed for the taxation year in which control changed.

2.060 The following example illustrates the computation of Part VI tax:

Example

Assume	
—Preferred rate amount	$160,000
—Part V tax at end of previous year	20,000
Part VI tax payable	
Preferred-rate amount	$160,000
Deduct 4 times Part V tax	80,000
Amount subject to Part VI tax	$ 80,000
Tax payable 25% thereof	20,000
Annual instalments $^1/_5$ of $20,000	$ 4,000

2.061 Part VI tax is not applicable where a Canadian-controlled private corporation becomes a public corporation, or when control of such corporation is transferred to a public corporation.

PART IV TAX ON DIVIDENDS RECEIVED BY PRIVATE CORPORATIONS

Purpose of Part IV Tax

2.062 Part IV of the Act requires private corporations to pay a special tax of 33⅓% of the amount of certain dividends received which are deductible in computing taxable income. Because this tax is approximately equal to the amount which an individual taxpayer, whose marginal rate is 50%, would be required to pay on receipt of the same dividends, it ensures that dividend income received by a private corporation will not attract considerably less tax than would the same income if received directly by individual shareholders.
186, 187

2.063 When a private corporation in turn pays a taxable dividend in an amount equivalent to its dividend income received, the corporation receives a refund of the Part IV tax. Because individual shareholders are taxed on such dividends in the normal manner and because all of the Part IV tax levied at the corporate level is returned, dividend income flowing through private corporations is ultimately taxed at the rates applicable to the individual shareholders of the corporation.

Liability for Part IV Tax

2.064 All private corporations, including non-Canadian-controlled private corporations, are liable to pay Part IV tax. Moreover, where a corporation was a private corporation at any time in a taxation year, it must pay Part IV tax in respect of its dividend income for the entire year notwithstanding the fact that it may have become a public corporation or a subsidiary to a public corporation in the course of the year.

Dividends Received Which Are Subject to Part IV Tax

2.065 The following dividends received by a private corporation after 1971 are subject to Part IV tax:

(a) Dividends received from taxable Canadian corporations, which corporations were not controlled by the recipient at the time the dividend was paid, to the extent that such dividends were deductible from the recipient's income in computing taxable income.

(b) Dividends received from non-controlled foreign affiliates to the extent that such dividends were deductible in computing the recipient's taxable income and were not treated as a return of capital.

(c) Dividends received from a controlled *private corporation* to the extent of the recipient's portion of an amount equal to 3 times the dividend refund of the payer corporation for the taxation year in which it paid the dividend. (See paragraphs 2.095 to 2.099 for an explanation of the dividend refund.)

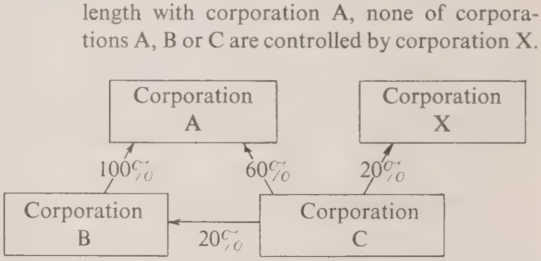
2.066 For the purpose of Part IV tax, a corporation is controlled if more than 50% of its voting share capital is owned by another corporation, by persons with whom that other corporation does not deal at arm's length, or by a combination thereof. For example, in the corporate structure depicted below:

(a) corporation B is controlled by corporation A (more than 50% of B's share capital belongs to A),

(b) corporation C is controlled by corporation A (more than 50% of C's share capital belongs to A),

(c) corporation C is also controlled by corporation B (more than 50% of C's share capital belongs to B (20%) and to A (60%) which does not deal at arm's length with B), and

(d) assuming that corporation X deals at arm's length with corporation A, none of corporations A, B or C are controlled by corporation X.



2.067 In this example, dividends received by corporation A from corporation B and C, and dividends received by Corporation B from corporation C, are not subject to Part IV tax except where such dividends have resulted in a dividend refund to the payer corporation. Dividends received by corporation X from corporation C are subject to Part IV tax. Part IV tax therefore applies mainly to portfolio dividend income except where dividends flowing between related companies result in a dividend refund to the payer. This exception is necessary to ensure that where Part IV tax has been paid in respect of dividend income received by a private corporation, such tax, in effect, is not refunded until a distribution of the dividend income is made to individual shareholders.

Application of Tax

2.068 Part IV tax applies at the rate of 33⅓% to the gross amount of all applicable dividends received by a private corporation in a taxation year. The amount subject to the Part IV tax, however, may be reduced at the taxpayer's option by

(a) all or a part of the corporations non-capital loss for the taxation year, and

(b) all or a part of the corporation's non-capital losses of the five preceding years and immediately following taxation year to the extent that they are not otherwise deductible in computing taxable income for the taxation year.

111(8) (b)

2.069 Where the corporation can reasonably expect to earn sufficient income in future years to absorb any non-capital losses carried over, it will not normally be advisable to claim such losses against dividends subject to Part IV tax since the rate is only 33⅓% compared with the normal corporate rate of approximately 50%, and since Part IV tax is fully refundable when dividends are paid. Where, however, a corporation typically incurs carrying charges in respect of tax-free dividend income in excess of non-dividend income, such excess will be available, in the form of a non-capital loss, to offset the amount of dividends subject to Part IV tax.

Personal Corporations — Transitional

2.070 The imposition of Part IV tax coupled with various other provisions of the new Act obviates the need for the personal corporation rules under the old Act. Consequently these rules are no longer applicable for taxation years commencing after 1971. Where a taxation year of a personal corporation commenced before January 1, 1972, and ended in 1972, the old rules still apply, and therefore such a corporation is not liable for Part IV tax in respect of that taxation year.

ITAR 57(2)

Filing of Returns and Payment of Part IV Tax

2.071 The corporation T2 income tax return contains a section for the calculation of the Part IV tax payable. This section should be completed by every corporation liable for Part IV tax. The Act provides that payment of the Part IV tax should be made in full on the last day of the third month after the end of the taxation year. Instalment payments are not required.

2.072 An example of Part IV tax payable appears below.

Example

Assume:

(a) Company B, a private corporation, has income and expenses for 1972 as follows:

(i) Net business income	$10,000
(ii) Dividends from non-controlled taxable Canadian corporations	$ 3,000
(iii) Expenses incurred re dividend income	$ 100

(b) Company A, a private corporation, owns 60% of the voting shares of Company B.

(c) Company B pays a dividend of $6,000 in 1973 and its dividend refund for 1973 is $1,000. (Note—The dividend refund is discussed in detail in paragraphs 2.095 to 2.099).

(d) Company A, whose only income in 1973 is the dividend from Company B, incurs expenses in connection therewith of $500.

Computation of Taxable Income of Company B

Net business income	$10,000
Dividends from non-controlled taxable Canadian corporations	3,000
	13,000
Less expenses	100
Income	12,900
Less dividends from non-controlled taxable Canadian corporations	3,000
Taxable income	$ 9,900

Tax Payable by Company B

Part I	
Tax on taxable income (assumed rate of 50%)	$ 4,950
Part IV	
33⅓% of dividends from non-controlled taxable Canadian corporations (33⅓% of $3,000)	1,000
Total tax payable	$ 5,950

Note:

Part IV tax applies on the gross amount of dividends received. The expenses in connection with the dividends are effectively absorbed against other income.

Computation of 1973 Taxable Income of Company A

Dividend received from Company B (60% of 6,000)	$3,600
Less—Expenses	500
Income	3,100
Less—Dividends from Company B	3,600
Taxable income	NIL

Computation of Non-Capital Loss of Company A

(For details of calculation of non-capital loss see paragraphs 1.044 to 1.047)

Loss from business or property	NIL
Add Dividends deducted in computing taxable income (as above)	$3,600
	$3,600
Deduct Income (as above)	3,100
Non-capital loss	$ 500

Tax Payable by Company A

Part I		
Tax on taxable income		NIL
Part IV tax		
Amount subject to Part IV tax— 3 times Company B's dividend refund (3 × $1,000)	$3,000	
Company A's share thereof (60% of $3,000)	1,800	
Less Non-capital loss	500	1,300
Tax thereon at 33⅓%		$ 433

Notes:

(1) As Company A had no income in 1973 other than the dividend from Company B, the total expenses of $500 become a non-capital loss for the year.

(2) If Company A anticipates income other than dividend income for future years, it may not be advisable to claim the non-capital loss to reduce Part IV tax. A greater advantage might be realized if the non-capital loss were carried over to offset income in future years which is taxable at full corporate rates.

DISTRIBUTIONS OF EARNINGS OF PRIVATE CORPORATIONS

2.073 The new rules for the taxation of the income of private corporations earned after 1971 are designed to achieve two basic objectives, which are

(1) that income earned by a private corporation is not subject to tax at the corporate level at rates substantially lower than rates imposed on income earned directly by individuals, and

(2) that, in general, the total tax payable by a private corporation and its individual shareholders after income is distributed is no greater than the tax that would have been payable if the shareholders had personally received the income. This objective pertains to investment income, and to income from active business which is subject to the small business deduction.

2.074 The first objective is achieved by the imposition of tax at the normal rate of approximately 50% on the income of a private corporation (except Canadian active business income up to certain maximums which is taxed at only 25%), and the imposition of the 33⅓% Part IV tax on certain dividends received by the corporation.

2.075 Where taxable dividends are paid by a private corporation, such dividends are included in computing the income of the individual shareholder and are therefore subject to tax in his hands. Since the dividend tax credit formula effectively provides a tax credit of only 25 percentage points of corporate tax, special rules are necessary with regard to investment income of a private corporation if the second of the above objectives is to be attained.

2.076 These rules can be summarized as follows:

(a) Where the private corporation pays a taxable dividend, an appropriate portion of the taxes paid at the corporate level is refunded to the corporation. This refund is calculated in a manner which ensures that where tax-free dividends received by the private corporation are in turn considered to be distributed to shareholders, all of the Part IV tax paid in respect of the dividends is refunded. Moreover, where other investment income earned by the corporation is distributed, the effect of the refund is that the ultimate Part I tax paid thereon at the corporate level does not exceed 25%.

(b) The untaxed half of capital gains realized by the private corporation may be distributed tax-free to its shareholders as capital dividends.

2.077 These rules are discussed under the headings Refundable Dividend Tax, Dividend Refunds, and Capital Dividends.

2.078 Concerning dividends paid out of pre 1972 corporate surpluses, the rules under this heading in Chapter 1 apply to private corporations as well, of course.

Refundable Dividend Tax

2.079 When a private corporation pays taxable dividends it will be eligible for a refund of certain corporate taxes previously paid. As mentioned in paragraph 2.063 the Part IV tax paid is refundable. The total amount available for refund (refundable dividend tax) however, is not restricted to only Part IV tax. The refundable dividend tax on hand is composed of the aggregate of

(a) all of the Part IV tax paid in respect of dividends received, and

(b) a maximum of 25 percentage points of the Part I tax paid in respect of other investment income, both Canadian and foreign

less

(c) amounts previously refunded.

2.080 The amounts in (a) and (b) determined in respect of a particular taxation year are, in effect, placed in a refundable dividend tax account and the account is reduced by any dividend refunds made.

2.081 The balance in the refundable dividend tax account (refundable dividend tax on hand) at the end of any particular taxation year includes the Part IV tax and the relevant portion of the Part I tax paid in respect of that particular taxation year, but such balance is determined before deducting the dividend refund in respect of dividends paid in that particular taxation year.

2.082 Since all of the Part IV tax paid by a private corporation is eligible for refund, the amount to be included in the refundable dividend tax account for a particular taxation year is simply the amount payable in respect of that year. The determination of the amount to be included in the refundable dividend tax account in respect of Part I tax is discussed in detail below.

Definition of Investment Income

2 083 For the purpose of calculating the refundable portion of Part I tax on investment income, which is to be added to the refundable dividend tax account, investment income consists of the aggregate of:

(a) taxable capital gains less allowable capital losses,

(b) net income from property, other than exempt income and dividends which are deductible in computing taxable income,

(c) net income from non-active business,

less the aggregate of:

(d) property losses,

(e) non-active business losses.

2.084 Investment income from Canadian sources and investment income from foreign sources must be calculated separately.

Formula for Calculation of Refundable Part I Tax on Investment Income

2.085 For most ordinary situations, the corporation T2 return provides a schedule necessary for making the required calculations under the formula described below. The remarks under this heading and the examples which follow later are to assist the reader in understanding why the formula is necessary, and how it operates.

2.086 Where a corporation's only income for a taxation year is investment income from Canadian sources as defined above, and no deductions have been made from income to arrive at taxable income other than for taxable dividends received, the refundable portion of the Part I tax is simply an amount equal to 25% of the investment income. Where, however, the calculation of a corporation's income or taxable income includes components such as foreign source investment income subject to foreign tax credits, active business income subject to the small business deduction, and deductions for net capital losses, non-capital losses, or charitable donations, the calculation of the amount of Part I tax subject to refund is necessarily more complex. Depending on the particular situation of a corporation, one of four restrictions might apply to limit the amount of refundable tax to less than 25% of investment income. Specifically the amount of Part I tax which may be designated as refundable is an amount equal to the least of

(1) 25% of the amount by which the aggregate of the corporation's Canadian Investment Income and foreign investment income for the year exceeds any net capital loss deductible in computing taxable income for the year,

(2) the amount by which the aggregate of

(i) 25% of the corporation's Canadian investment income for the year and

(ii) the amount by which 40% of the corporation's foreign investment income for the year exceeds the foreign tax deduction claimed in respect thereof

exceeds 25% of the amount of any net capital loss deductible in computing taxable income for the year,

(3) 25% of the amount by which the corporation's taxable income for the year exceeds the aggregate of

(i) 4 times the amount of the small business deduction for the year

(ii) $^{10}/_{4}$ of the foreign tax credit in respect of foreign investment income and

(iii) 2 times the foreign tax credit in respect of foreign business income, and

(4) the amount of Part I tax payable for the year after deductions for provincial mining abatements and logging tax credits, if any.

2.087 The first restriction above is necessary to ensure that the amount of refundable tax does not exceed 25 percentage points of Part I tax paid in respect of investment income determined after deducting any net capital losses, since investment income includes net capital gains but is computed before taking into account any net capital losses carried from other years.

2.088 The second restriction above ensures that where the effective Part I tax paid in respect of foreign investment income is reduced below 25% as a result of the allowance of a credit for foreign taxes paid, the maximum refundable amount cannot exceed the Part I tax actually paid in respect of the foreign investment income.

2.089 The third restriction above ensures that (assuming a Part I tax rate of 50%) only the excess of the Part I tax paid by the corporation over that which would have been payable had the rate been 25% is eligible for refund (i.e. 50% less 25 percentage points). Therefore, where deductions have been made from income to arrive at taxable income, where foreign tax credits have been claimed, and/or where a small business deduction has been made, the refundable portion of Part I tax may be limited to less than an amount equal to 25% of investment income.

2.090 The fourth restriction above is to ensure that in no event can the refundable amount exceed Part I tax actually paid by the corporation.

Change in Status of Corporation

2.091 The Act provides that a portion of Part I tax on investment income may be refundable only in respect of taxation years commencing after the corporation last became a private corporation. If a public corporation becomes a private corporation during a taxation year, no part of its Part I tax for the year is refundable. Any Part IV tax paid in respect of a taxation year during which a public corporation becomes a private corporation, however, will be refundable.

Transitional Rules

2.092 Where a taxation year of a private corporation straddles December 31, 1971, it is only the investment income that can be reasonably regarded as having been earned in the 1972 calendar year which will give rise to refundable tax. This amount is calculated as the net taxable capital gains plus that proportion of the investment income (excluding capital gains and losses) that the number of days in the taxation year falling in 1972 bears to the number of days in the whole taxation year.

Filing of Returns

2.093 The corporation T2 return provides for the calculation of refundable dividend tax for each taxation year. If the corporation has foreign income, however, a schedule showing the calculation of the refundable portion of Part I tax should be attached.

Examples

2.094 The following examples illustrate the computation of the amount which would be added to the refundable dividend tax account and thus would be eligible for a dividend refund as described in paragraphs 2.095 to 2.099.

EXAMPLE 1

Assume—			
Taxable dividends received			$3,000
Canadian investment income			2,000
Income			5,000
Less—Taxable dividends received			3,000
Taxable income			$2,000
Part I tax thereon Assumed rate of 50%		$1,000	
Provincial Abatement (10% of taxable income)		200	
Total Part I tax			$ 800
Part IV tax thereon			
⅓ of Taxable Dividends (⅓ of $3,000)			$1,000
Amount to be added to the Refundable Dividend Tax Account			
(a) All of Part IV tax			$1,000
(b) Part I tax equal to the least of:			
(1) 25% of investment income net of capital loss carried over (25% of $2,000)		$ 500	
(2) 25% of Canadian investment income (25% of $2,000)		500	
40% of foreign investment income	nil		
Less foreign tax credit	nil	nil	
		500	
(3) Taxable income		2,000	
Less 4 × small business deduction		nil	
$^{10}/_{4}$ foreign tax credit re investment income		nil	
2 × foreign tax credit re business income		nil	
		2,000	
25% thereof		500	
(4) Part I tax payable net of mining tax abatement and logging tax credit		800	
Part I tax refundable—least of (1) to (4) above			500
Total refundable tax for the year			$1,500

Comments:

Since the preceding illustration is not complicated by foreign tax credits, small business deductions, or deductions made from income to arrive at taxable income (other than for dividends), the four limitations do not reduce the amount of Part I tax refundable to less than 25% of investment income.

EXAMPLE 2

Assume—

Taxable dividends received			$3,000
Canadian investment income			2,000
Business income (subject to small business deduction)			5,000
Income			$10,000
Less—Taxable dividends received		$3,000	
Non-capital loss carried forward		2,000	5,000
Taxable income			$5,000
Part I Tax thereon			
Assumed rate of 50%	$2,500		
Provincial abatement (10% of taxable income)	500		
	2,000		
Small business deduction (25% of $5,000)	1,250		$ 750
Part IV tax thereon			
⅓ of taxable dividends received (⅓ of $3,000)			$1,000

Amount to be Added to the Refundable Dividend Tax Account

(a) All of Part IV tax			$1,000
(b) Part I tax equal to the least of:			
(1) 25% of investment income (25% of $2,000)		$ 500	
(2) 25% of Canadian investment income		500	
40% of foreign investment income	nil		
Less foreign tax credit	nil	nil	
		500	
(3) Taxable income		$5,000	
Less:			
4 × small business deduction (4 × $1,250)	$5,000		
10/4 × foreign tax credit re investment income	nil		
2 × foreign tax credit re business income	nil	5,000	
		nil	
25% thereof		nil	
(4) Part I tax payable net of mining abatement and logging tax credits		750	
Part I tax refundable—least of (1) to (4) above			nil
Total refundable tax for the year			$1,000

Comments:

In this illustration the non-capital loss carried forward has reduced taxable income to $5,000 which represents the active business income eligible for the small business deduction. Because of the small business deduction, the actual Part I tax paid does not exceed that which would have been payable had the ordinary rate of tax been 25% on the total taxable income and no small business deduction had been allowed, i.e.

Taxable income		$5,000
Tax thereon at 25%	$1,250	
Less Provincial abatement	500	$ 750

Accordingly no portion of the Part I tax paid is refundable.

Example 3

Assume—

Taxable dividends received			$3,000
Canadian investment income			2,000
Foreign investment income (foreign tax paid $200)			1,000
Business income (*not* subject to small business deduction)			5,000
Income			11,000
Less—Taxable dividends received			3,000
Taxable income			$8,000
Part I Tax thereon			
Assumed rate of 50%		$4,000	
Provincial abatement (10% of taxable income)		800	
		3,200	
Less—Foreign tax credit		200	3,000
Part IV tax thereon			
⅓ of taxable dividends (⅓ of $3,000)			$1,000

Amount to be Added to the Refundable Dividend Tax Account

(a) All of Part IV tax			$1,000
(b) Part I tax equal to the least of			
(1) 25% of investment income net of any capital loss carried over			
Cdn. investment income	2,000		
For. investment income	1,000		
	3,000		
25% thereof		750	
(2) 25% of Canadian investment income (25% of $2,000)		500	
40% of foreign investment income			
(40% of $1,000) (Note 1)	$ 400		
Less—Foreign tax credit	200	200	
		700	
(3) Taxable income	8,000		
Less—4 × small business deduction	nil		
10/4 × foreign tax credit re investment income (10/4 × $200)	500		
2 × foreign tax credit re business income	nil		
	7,500		
25% thereof		1,875	

Example 3 (cont'd)

(a) All of Part IV tax (brought forward)		$1,000
(4) Part I tax payable net of mining tax abatement and logging tax credit	3,000	
Part I tax refundable—Least of (1) to (4) above		700
Total refundable tax for the year		$1,700

Note 1:

In the second limitation, where a rate of 40% is applied to foreign investment income, this rate is equivalent to the standard Part I tax rate of 50% less the provincial abatement of 10%. After deducting the foreign tax credit, this calculation determines the actual Part I tax paid in respect of foreign investment income.

DIVIDEND REFUNDS

2.095 A private corporation becomes entitled to a refund of the refundable dividend tax on hand upon the payment of taxable dividends to its shareholders. The amount of the refund in respect of any particular taxation year is equal to the lesser of:

(a) ⅓ of the taxable dividends paid in that particular taxation year and
(b) the refundable dividend tax on hand at the end of that particular taxation year.

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2.096 To qualify for a refund, a corporation must have been a private corporation at the end of the taxation year in which the taxable dividend was paid. No refund will be made in respect of dividends paid in the year that a private corporation becomes a public corporation (or a subsidiary to a public corporation) notwithstanding that the dividend may have been paid before the corporation became public and notwithstanding that there still may be a balance in the refundable dividend tax account.

2.097 Where any amount of tax due under the Act for a taxation year is required to be paid by instalments, each instalment payment may be reduced by $^1/_{12}$ of the dividend refund for that year. A private corporation therefore may minimize its instalment payments by taking into account anticipated dividend refunds. Any balance of the dividend refund not applied against instalments may be applied against any other tax payable under the Act or refunded to the corporation.

157(3), 129(2)

2.098 The ratio of the dividend refund to dividends paid (1 to 3) will enable the corporation to obtain a refund of the refundable tax paid in respect of investment income when an amount equivalent to such income, net of any non-refundable Part I tax paid by the corporation, is distributed to its shareholders. For example, where a private corporation earns interest income of $100, it will initially be liable to ordinary Part I rates of tax (say 50%), 25 percentage points of which is refundable and 25 percentage points of which is non-refundable and borne by the corporation. On payment of a taxable dividend of $75 (the interest income of $100 less the non-refundable tax of $25), a refund of the $25 refundable tax will be made (⅓ of $75). Similarly, where the corporation receives a taxable dividend subject to Part IV tax (⅓ of taxable dividends) all of the Part IV tax will be refunded when an amount equivalent to the dividend received is distributed to the corporation's shareholders in the form of a taxable dividend.

2.099 Since the maximum refund available upon the payment of a taxable dividend includes the amount of refundable dividend tax determined in respect of the taxation year in which the dividend was paid, and since a dividend refund may be offset against other tax liabilities as described above, a private corporation which chooses to distribute all its investment income (including taxable dividends received and subject to Part IV tax) in the same taxation year as received, in effect, will not be required to pay either Part IV tax or the refundable portion of Part I tax in respect of investment income.

CAPITAL DIVIDENDS

2.100 The Act provides that a private corporation may accumulate the non-taxable portion of certain gains in a capital dividend account and, if the corporation so elects, may pay a tax-free dividend (capital dividend) to its shareholders from such account. This provision ensures that the non-taxable portion of gains realized by the private corporation remains tax-free when distributed to individual shareholders.

83(2)

2.101 The capital dividend account is comprised of the following amounts for the period commencing with the taxation year after the corporation last became a private corporation and ending with the taxation year before that in which the particular capital dividend is paid;

(a) the non-taxable ½ of capital gains net of ½ of capital losses realized in the period and after 1971,

(b) capital dividends received from other private corporations in the period (to ensure that the individual shareholders are placed in the same

position where capital dividends pass through a chain of corporations),

(c) the non-taxable ½ of gains realized on the sale of goodwill and other nothings in the period and after 1971. (Such amount is generally the excess of ½ the proceeds, or deemed proceeds determined under the Income Tax Application Rules, on the sale of goodwill or other nothings in the period over the non-allowable ½ of the eligible capital expenditures incurred in the period.) Eligible capital expenditures are discussed in detail in paragraphs 1.006 to 1.013 and

(d) life insurance proceeds on the death of the insured received in the period and after 1971 net of any premiums paid in connection therewith, less

(e) capital dividends paid in the period.

89(1) (b)

2.102 Where a private corporation so elects, the full amount of any particular dividend will be regarded as a capital dividend provided that:

(a) the corporation did not have any 1971 undistributed income on hand or tax-paid undistributed surplus on hand at the time the dividend was paid and

(b) the amount of the dividend did not exceed the balance in the capital dividend account at the end of the taxation year preceding that in which the dividend was paid less any capital dividends previously paid in the same taxation year.

2.103 If the corporation had a balance of 1971 undistributed income on hand or a balance of tax-paid undistributed surplus on hand at the time the dividend was paid, it is only the portion of the dividend in excess of these amounts that will be regarded as a capital dividend. Moreover to the extent that the amount of the dividend (after deducting the 1971 undistributed income on hand and tax-paid undistributed surplus on hand, if any) exceeds the capital dividend account at the end of the taxation year preceding that in which the dividend was paid (less capital dividends paid in the same taxation year) such excess will not be regarded as a capital dividend.

2.104 A private corporation which elects in respect of a dividend, any part of which is not regarded as a capital dividend for the reasons noted above, is liable for a tax, under Part III of the Act, in an amount equal to that portion of dividend which does not qualify as a capital dividend. The full amount of the dividend, however, remains tax-free to shareholders.

184(2)

2.105 Although a capital dividend need not be reported on Form T5 slips, it is important to inform shareholders that the dividend is not to be included in computing their incomes, and that the dividend does not reduce the cost base of their shares. It is also important to inform corporate shareholders that the dividend is a capital dividend since such dividends received increase their capital dividend accounts.

2.106 The following example illustrates the computation of a capital dividend account:

	Capital Dividend Account		
	1972	1973	1974
Non-taxable ½ of capital gains	$2,000	$1,500	$2,000
Less—½ of capital losses	—	(5,000)	(500)
Net	2,000	(3,500)	1,500
Capital dividends received	—	2,000	
Non-taxable gain on sale of goodwill (proceeds $4,000, see Note 1)	—	—	1,000
Life insurance proceeds net of premiums paid			2,000
	2,000	(1,500)	4,500
Balance at end of preceding year	—	2,000	(1,500)
	2,000	500	3,000
Capital dividends paid (Note 2)	—	(2,000)	—
Balance at end of year	$2,000	$(1,500)	$3,000

Note 1

Assuming that the corporation did not incur any eligible capital expenditures in the period 1972-1974, the non-taxable gain on sale of goodwill in 1974 is calculated as follows (also assuming that the goodwill related to a business carried on by the corporation on January 1, 1972):

Actual proceeds	$4,000
Deemed proceeds under Income Tax Application Rules (50% of $4,000)	$2,000
Non-taxable portion of deemed proceeds (½ of 2,000)	$1,000

Note 2

It is important to note that capital dividends may be paid in any year to a maximum of the capital dividend account balance at the end of the preceding year. Therefore in this example, a capital dividend may be paid anytime in 1973 to a maximum of $2,000 notwithstanding that the account is reduced in 1973 by capital losses. If such a dividend is paid, however, the corporation must recoup, in subsequent years, the $1,500 deficiency that would be created in the account at the end of 1973 before any further capital dividends can be paid.

Chapter 3

PAYMENTS, OVERPAYMENTS, AND REFUNDS

PAYMENTS AND REFUNDS OF TAX

3.001 The new Act provides rules similar to those contained in the old Act regarding payments and overpayments of tax. In addition, the new Act provides for the payment and the refund in some cases of new types of taxes that it introduced. Set out below is a brief summary of these provisions. More detailed information can be obtained by referring to the relevant Sections of the new Act.

Payment of Tax

3.002 Part I tax which is referred to in paragraphs 1.074 to 1.079 and Part XII tax, (tax on Investment Income of Life Insurers) are required to be paid in instalments. Generally instalments are payable monthly, beginning at the end of the first month of the taxation year. The amount may be based on an estimate for the current year or upon the results of the previous year.

Any balance of tax payable for the year after making such instalments is due on the last day of the third month following the end of the taxation year.

3.003 Where a corporation has a taxation year which straddles December 31, the tax rate will be different (at least until 1976) for each of the calendar years falling in the taxation year. The method of calculating the tax for such a taxation year is illustrated in paragraph 1.076.
ITAR 52

3.004 Part IV tax on taxable dividends received by private corporations referred to in paragraphs 2.062 to 2.071 and Part V tax on Ineligible Investments referred to in paragraphs 2.044 to 2.055 are due on the last day of the third month following the end of the taxation year.
186, 188

3.005 Part VI tax, which is payable when a Canadian-controlled private corporation becomes non-Canadian-controlled, is due in equal annual instalments. The first instalment is due on or before the last day of the sixth month after the end of the taxation year in which the corporation became a non-Canadian-controlled private corporation. The description of this tax is contained in paragraphs 2.056 to 2.061.
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3.006 The following taxes are payable on the last day of the sixth month following the end of the taxation year:

(a) Part II —Tax on redemption or acquisition by a corporation of its capital stock —see Chapter 4.

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(b) Part VII —Tax on recipient of dividend paid out of designated surplus — see Chapter 4.

192

(c) Part VIII—Tax on corporation paying dividend out of designated surplus — see Chapter 4.

194

(d) Part XIV—Additional tax on corporations (other than Canadian corporations) carrying on business in Canada — see Chapter 7.

219

3.007 Part III tax on excessive elections (see paragraphs 1.110 and 1.111) and Part IX tax on 1971 undistributed income on hand (see paragraph 1.097) are due at the time of the election.
184, 196

3.008 The Act provides for interest charges, at a rate to be prescribed, when instalments and unpaid taxes are not paid when due. Penalties may also be payable if returns are not filed when due, or do not contain the required information.
161, 162

Overpayments

3.009 Where a return of income showing a refund due to a taxpayer is filed within four years from the end of a taxation year, the refund may be made

(a) upon mailing the notice of assessment without application therefor, and
(b) shall be made after mailing the notice of assessment if application is made therefor by the taxpayer within 4 years from the end of the taxation year in which the refund arose.

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3.010 Interest at a rate prescribed by regulation will be credited on overpayments. Where the overpayment results from a successful objection or appeal against an assessment, interest will be credited at a rate, not necessarily the same, prescribed by regulation.

Refunds of Refundable Dividend Tax on Hand

3.011 Where a corporation is entitled to a dividend refund as discussed in paragraphs 2.095 to 2.099, such refund,

(a) may be made upon mailing the notice of assessment, and

(b) shall be made after mailing the notice of assessment where application in writing has been made within four years from the end of the year in respect of which the refund arose.

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3.012 A taxpayer who expects that he will meet the conditions for a dividend refund may reduce his monthly income tax instalment payments, referred to earlier, by $^{1}/_{12}$ of such refund. Any balance of the dividend refund will be refunded as outlined above. There is no interest credited on dividend refunds. See paragraph 2.097.

Refunds of Part V Tax

3.013 Part V tax on Ineligible Investments is refundable as outlined in paragraph 2.053. When a corporation is entitled to such refund

(a) it may be made upon mailing the notice of assessment, and

(b) it shall be made after mailing the notice of assessment where application in writing has been made within four years from the end of the year in respect of which the refund arose,

and no interest is credited on refunds of Part V tax.

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Part IX Tax

3.014 If a controlled corporation resident in Canada elects to be taxed on its 1971 undistributed income on hand under Part IX, and then distributes that income to its shareholders, the Minister may make a refund to the controlling corporate shareholder in respect of some or all of the Part IX tax paid as outlined in paragraph 1.108. No interest will be credited with regard to such refund.

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Application of Refunds to Other Taxes

3.015 If a taxpayer is liable or about to come liable to make another payment under the Income Tax Act, an overpayment of tax, a dividend refund or a refund of Part V tax may be applied to that liability instead of being refunded.

Chapter 4

DEEMED DIVIDENDS AND DESIGNATED SURPLUS

4.001 One of the basic assumptions underlying the system for the taxation of corporations and their shareholders is that income earned by a corporation retains its character as income when it is paid out to individual shareholders. Therefore, in general, distributions of corporate earnings are taxed in the hands of individual shareholders at ordinary personal rates less a specified dividend tax credit in recognition of corporate taxes previously paid.

4.002 Although the accumulated income of a corporation will usually be paid out in the form of dividends, corporate earnings may also be distributed in other ways such as by payments in connection with the reduction, redemption or cancellation of any of the capital stock of the corporation. To ensure that all corporate distributions of earnings are treated in substantially the same manner as dividends paid, the Act contains special provisions designed to cover those situations where a corporation's income is effectively paid out to shareholders otherwise than by way of dividends. These provisions are discussed under the headings Return of Capital, Reductions in Share Capital, Tax on Redemption or Acquisition of Capital Stock, Capitalization of Surplus and Designated Surplus.

RETURN OF CAPITAL

4.003 The new Act contemplates that where a corporation makes a distribution to shareholders and as a consequence of such distribution the share capital of the corporation is reduced, any amount paid to a particular shareholder is regarded first as a non-taxable return of capital to the extent of the reduction in the share capital and then as a distribution of earnings. This is essentially a new concept since the old Act provided that where funds or property were distributed to shareholders in connection with a reduction in common share capital the amount so paid out was first regarded as a distribution of income to the extent of the undistributed income on hand (retained earnings for tax purposes) and only after as a return of capital. Because all corporate distributions under the provisions of the new Act are regarded as income distributions to the extent that they exceed any reduction in share capital, the concept of undistributed income on hand loses its significance (except where it becomes relevant in determining designated surplus, see paragraphs 4.029 to 4.032). Conversely the concept of "paid-up capital" assumes prime importance.

4.004 The paid-up capital in respect of a share of any class of the capital stock of a corporation is defined by the Act to be an amount equal to the paid-up capital of the corporation that is represented by that particular class of shares, divided by the number of issued and outstanding shares of that class. It is, therefore, only the amount to the credit of the capital stock accounts that is relevant in determining the paid-up capital in respect of any share. Any amount credited to a contributed surplus account in respect of premiums arising on the issuance of shares does not form part of a corporation's paid-up capital. Ordinarily any payment on the reduction of share capital of a corporation to the extent of the paid-up capital of the particular shares involved is regarded as a tax-free return of capital to the shareholder. In certain cases, however, the maximum amount that may be considered as a return of capital is less than the total paid-up capital of the corporation.
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4.005 To facilitate the introduction of the new system of taxation as it relates to corporations and their shareholders, the Act contains special provisions concerning the position of a corporation at the end of its 1971 taxation year. In simple terms these provisions envisage the preparation of the corporate balance sheet on a tax basis. Where, at the end of the 1971 taxation year, the tax value of a corporation's net assets (tax equity, see paragraph 1.114) is not sufficient to cover both the undistributed income on hand (as calculated from 1950 to 1971) and the paid-up capital of the corporation, the shortfall is referred to as a paid-up capital deficiency.

4.006 Although the paid-up capital deficiency in this case is initially computed as at the end of a corporation's 1971 taxation year, the amount may be subject to change in subsequent years. For example the amount of any accrued capital gains as at the end of 1971 reduce the paid-up capital deficiency when subsequently realized. Conversely accrued capital losses increase the deficiency when realized in subsequent years.

4.007 A paid-up capital deficiency can also arise after 1971, such as where shares of a corporation have been

issued after 1971 in exchange for property and the corporation and the shareholder have elected to have the rollover provisions apply (paragraph 5.004). If a corporation issues shares having a paid-up capital of $100 in exchange for property with a fair market value of $100 but the corporation and the shareholder have elected to fix the transfer price at $80 a paid-up capital deficiency of $20 will be created as a result of the transaction. The detailed formula for the calculation of paid-up capital deficiency is included in paragraph 4.010.

4.008 Where a paid-up capital deficiency exists the maximum amount which may be regarded as a non-taxable return of capital is the paid-up capital of the corporation less the amount of the paid-up capital deficiency. This amount is referred to as the paid-up capital limit of the corporation.

4.009 The following is an illustration of the calculation of the paid-up capital limit of a corporation:

Assume

(a) the position of X Company on December 31, 1971, the end of its 1971 taxation year is as shown below

X Company
Balance Sheet
December 31, 1971

Assets

Investments—at cost (market value on V-Day, $12,000)	$10,000
Depreciable property—at cost less accumulated depreciation, (undepreciated capital cost—$10,000)	15,000
Goodwill—at cost	20,000
Other assets—at tax values	50,000
	$95,000

Liabilities and Shareholders Equity

Liabilities			$30,000
Shareholders' Equity			
Capital Stock			
Preferred	$10,000		
Common	15,000	$25,000	
Retained Earnings (undistributed income 1950-1971 $35,000)		40,000	65,000
			$95,000

(b) On September 1, 1972 X Company sold its investments for $15,000.

Calculations of Paid-up Capital Limit

Paid-up Capital			$25,000
Less:			
Paid-up capital deficiency			
Paid-up capital		$25,000	
Undistributed income on hand (1950-1971)		35,000	
		$60,000	
Less:			
Tax Equity			
Investments—at cost	$10,000		
Depreciable Property—at undepreciated capital cost	10,000		
Other assets—at tax values	50,000		
	70,000		
Liabilities	30,000		
Tax equity		40,000	
Paid-up capital deficiency			20,000
Paid-up capital limit, on or before September 1, 1972			5,000
Add:			
Capital gain accrued at December 31, 1971,—realized September 1, 1972			
lesser of (i) proceeds $15,000 or			
(ii) V-Day value $12,000		12,000	
deduct—cost		10,000	2,000
Paid-up capital limit after September 1, 1972			$ 7,000

Calculation of Paid-up Capital Deficiency

4.010 The paid-up capital deficiency of a corporation is the amount by which the aggregate of

(a) the paid-up capital of the corporation at the end of its 1971 taxation year,

(b) the amount of the corporation's undistributed income on hand as calculated under the old Act for the taxation years 1950 to 1971 inclusive,

(c) losses realized after December 31, 1971, on capital property owned by the corporation at December 31, 1971, equal to the amount by which the actual cost of the property to the corporation exceeds the greater of the fair market value of the property on valuation day and the proceeds of disposition of the property,

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(d) losses realized on capital property owned at the end of the corporation's 1971 taxation year, or acquired thereafter, but disposed of on or before December 31, 1971, equal to the amount by which the actual cost of the property exceeds the proceeds of disposition of the property,

(e) the excess of the paid-up capital of any shares issued after 1971 for mining property acquired from a prospector or grubstaker over the deemed cost of such property to the corporation,

(f) where capital stock has been issued in exchange for capital property or eligible capital property by virtue of a transaction in respect of which the shareholder and the corporation have elected to have the rollover provisions apply, (see paragraph 5.004) the amount by which the excess of the paid-up capital of the particular shares issued over the deemed cost of the property to the corporation exceeds the excess of the paid-up capital of the shares issued over the fair market value of the property,

exceeds the aggregate of

(g) the tax equity of the corporation at the end of its 1971 taxation year (see paragraph 1.114),

(h) gains realized after December 31, 1971, on capital property owned by the corporation at December 31, 1971, equal to the amount by which the lesser of the fair market value of the property on valuation day and the proceeds of disposition exceeds the actual cost of the property,

(i) gains realized on capital property owned at the end of the corporation's 1971 taxation year, or acquired thereafter, but disposed of on or before December 31, 1971, equal to the amount by which the proceeds of disposition of the property exceeds the actual cost of the property,

(j) the amount of any dividends received by the corporation after 1971 out of the payor corporation's pre-1972 surplus except to the extent that the dividend was paid out of the payor's tax-paid undistributed surplus on hand,

(k) ½ of the amount by which the actual proceeds on the sale of goodwill and other nothings by a private corporation exceeds the deemed proceeds as calculated under ITAR,

(l) the amount of any dividends deemed to have been previously paid by the corporation in connection with a reduction in the paid-up capital of the corporation's shares (as described in paragraphs 4.011 to 4.016) to the extent that the paid-up capital of the particular shares exceeded the paid-up capital limit of the corporation at the time the dividend was paid,

(m) the amount by which a reduction of paid-up capital of the corporation after its 1971 taxation year exceeds the amount paid to the shareholders on such reduction,

(n) the amount of any business losses of the corporation incurred before the corporation's 1972 taxation year to the extent that such losses have been deducted in computing taxable income in the 1972 and subsequent taxation years,

(o) where a corporation has been subject to tax under Part II of the Act in respect of the acquisition of its shares in the open market, the amount by which the paid-up capital of the shares acquired exceeded the paid-up capital limit of the corporation.

REDUCTIONS IN SHARE CAPITAL

4.011 Where a corporation has reduced its share capital by virtue of

(a) the winding-up, discontinuance or reorganization of its business,

(b) the redemption, acquisition or cancellation in any manner whatever of any of its shares, or

(c) the reduction of the paid-up capital in respect of any shares of capital stock in any other manner,

the following rules described under this heading are applicable.

4.012 The value of any funds or property distributed by a corporation in connection with a transaction described above is regarded as a non-taxable return of capital to the shareholders to the extent of the lesser of

(a) the amount by which the paid-up capital of the shares has been reduced, and

(b) the paid-up capital limit of the corporation. *84(2)(3)(4)*

Subject to certain exceptions discussed in paragraphs 4.017 to 4.020, any payment in excess of the amount considered as a return of capital is deemed to have been

paid by the corporation as a dividend. For example, based on the facts as set out in the preceding illustration (paragraph 4.009) if Company X redeemed its preferred stock having a paid-up capital of $10,000, only $7,000 is considered as a return of capital since this is the paid-up capital limit of the corporation. The balance of $3,000 is a deemed dividend to the preferred shareholders of Company X. The amount that is deemed to have been received by a particular shareholder as a dividend is calculated as the proportion of the total deemed dividend that the number of preferred shares held by that shareholder immediately prior to the reduction of paid-up capital bears to the total number of preferred shares that were issued and outstanding at that time. Where the corporation has more than one class of shares outstanding, the amount of any deemed dividend is computed separately in respect of each class of shares and a shareholder's portion of a deemed dividend on a particular class of shares is determined with reference to the number of issued and outstanding shares of that class.

4.013 Deemed dividends are treated in the same manner as any ordinary dividend paid. For example, a corporation may elect to treat the deemed dividend as having been paid from tax-paid undistributed surplus on hand, or from 1971 capital surplus on hand, if the requirements for making this election are met. Similarly a private corporation may elect to treat the deemed dividend as having been paid from its capital dividend account.

4.014 For the purpose of determining a capital gain or loss where a shareholder has disposed of his shares as a result of the corporation having wound up or as a result of the corporation having redeemed, acquired or otherwise cancelled his shares, the amount of any dividend deemed to have been received by him is deducted from the total amount received from the corporation in computing the proceeds of disposition.

54(h)

4.015 Any amount received by a shareholder in consequence of the corporation having reduced its paid-up capital without having redeemed or otherwise cancelled any of its shares is deducted in determining the adjusted cost base of the shareholders' shares to the extent that such amount is a return of capital and not a deemed dividend.

53(2) (iv)

4.016 In determining whether a dividend is deemed to have been received by the shareholders of a corporation as a result of a transaction occurring in the corporation's 1972 taxation year, but before 1972, the provisions of the old Act apply. For this purpose, however, the undistributed income on hand is calculated in accordance with Section 33 of the Income Tax Application Rules.

TAX ON REDEMPTION OR ACQUISITION OF CAPITAL STOCK

4.017 The general provisions regarding deemed dividends on the reduction of share capital (paragraph 4.011) are not applicable in the following circumstances

(a) Where a corporation, other than a non-resident owned investment corporation, redeems or acquires any of its shares, other than common shares, at a premium and

(i) the shares were issued on or before June 18, 1971 (the date on which the new Act was introduced in the House of Commons),

(ii) the maximum amount of the premium was specified in the corporation's charter on or before June 18, 1971, and was not increased since that date,

the amount of the premium is not deemed to be a dividend in the shareholder's hands. The corporation, however, is liable to pay a special tax under Part II of the Act in respect of the premium. Where the share was issued on or before February 19, 1953, and the maximum premium was specified in the corporation's charter on or before that date and not subsequently increased, the Part II tax is 20% of the amount of the premium. In any other case, Part II tax is 20% of the amount of the premium where the premium does not exceed 10% of the par or stated value of the share, and 30% where the premium is more than 10% of the par or stated value of the share.

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These provisions, which are the same as those contained in Section 105A of the old Act, are designed to treat the premium on redemptions of preferred shares which were issued before the new Act was introduced in the House of Commons in the same manner as under the old Act. It is important to note that the rules set forth above are only applicable to any premiums paid on the redemption. A deemed dividend may also arise on the redemption if the paid-up capital of the shares redeemed exceeds the paid-up capital limit of the corporation.

(b) Where the provisions described in (a) above are not applicable and where a corporation has, after 1971, purchased any of its shares (including common shares) in the open market, in the manner in which shares would normally be purchased by any member of the public in the open market, the corporation is required to pay a tax under Part II equal to 25% of the amount by which the purchase price paid exceeds the lesser of

(i) the paid-up capital of the particular shares redeemed or acquired, and

(ii) the paid-up capital limit of the corporation immediately before the purchase.

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4.018 Where Part II tax is payable by a corporation as a result of an open market acquisition, no dividend is deemed to have been paid by the corporation. Part II tax is therefore payable by the corporation in lieu of the tax which would have otherwise been payable by the shareholders had the amount of the excess of the purchase price over the paid-up capital of the shares acquired been deemed to have been paid as a dividend. Such a provision is necessary because a shareholder who sells his shares in the open market may not be aware that the corporation has purchased those shares, and because it may be virtually impossible to ascertain the previous owner of a share purchased in the open market.

4.019 A corporation which has redeemed or acquired any of its shares, other than common shares, at a premium in its 1972 taxation year, but before June 19, 1971, may elect to treat all or a portion of such premium as having been paid out of its tax-paid undistributed surplus on hand in lieu of paying the Part II tax in respect of the premium.

4.020 Every corporation which has purchased any of its shares in the open market or which has redeemed or acquired any of its shares, other than common shares, in a taxation year is required by the Act to file a return of the transaction in prescribed form on or before the end of the sixth month following the end of the taxation year. Any Part II tax applicable in respect of the transaction must also be paid before that time.

CAPITALIZATION OF SURPLUS

4.021 The Act provides that a corporation is deemed to have paid a dividend to the extent that any transaction increases the corporation's paid-up capital by more than the corresponding increase in the value of its net assets. Since the paid-up capital of the corporation is tax-free on distribution, the provision is necessary to ensure that past or future earnings of the corporation may not be converted to capital in such a manner that the shareholders would avoid the payment of tax. Where corporate surplus has been capitalized in connection with the payment of a stock dividend, however, the provision does not apply because stock dividends are taxed as ordinary dividends under other provisions of the Act.

4.022 The amount of a dividend deemed to have been received by a shareholder of a particular class of shares is the amount of the increase in the paid-up capital of the shares of that class less the amount of the increase in the value of the net assets and the amount of the decrease in the paid-up capital of any other class of shares. The amount of the deemed dividend is then prorated according to the number of shares of the particular class outstanding immediately after the dividend is deemed to have been paid.

4.023 The amount of any dividend deemed to have been received by a shareholder on the capitalization of surplus is added to the adjusted cost base of his shares.

DESIGNATED SURPLUS

4.024 Under the new Act, capital gains realized on the sale of shares to the extent that they reflect taxable corporate surplus will continue to be taxed at a more favourable rate than will distribution of that surplus as taxable dividends for taxpayers with marginal rates above 40%. Since the sale of a corporation's shares will effectively precipitate tax on the corporate surplus only at capital gains rates, the Act generally provides that where a controlling interest is acquired in a corporation by a person who would not otherwise be subject to tax on taxable dividends received from the corporation, a special tax is payable in respect of taxable dividends received from the pre-acquisition surplus (designated surplus) of the corporation. This provision is similar to the concept of designated surplus under the old Act.

4.025 The application of the special tax in respect of taxable dividends out of designated surplus varies according to the particular status of the person who acquired control of the corporation. Another corporation or an unincorporated trader or dealer in securities is liable to a tax under Part VII of the Act of 25% on the amount of the taxable dividend considered to have been received from the designated surplus of the corporation which it controls. Where a corporation is controlled by a non-resident corporation or a non-resident owned investment corporation, the payer corporation must pay a tax of 15% under Part VIII of the Act in respect of any taxable dividend paid out of designated surplus. Similarly the

payer corporation must pay a tax of 33⅓% under Part VIII on a taxable dividend paid out of designated surplus if the person who controls the corporation is a person exempt from tax under Section 149 of the Act.
192, 194

4.026 For the purpose of the designated surplus provisions, a corporation is considered to be controlled by a person described above if more than 50% of the corporation's voting stock belongs to that person, to a person with whom that person does not deal at arm's length, or to a combination thereof. For example, where Corporation A and Corporation B do not deal at arm's length, and Corporation A owns 40% of the voting shares of Corporation C, and Corporation B owns 20% of the voting shares of Corporation C, both A and B are considered to control C. Consequently any taxable dividends received by A or B out of the designated surplus of C will be subject to the Part VII tax of 25%.

4.027 In general, taxable dividends paid or deemed paid by a controlled corporation come first out of earnings in the control period available for the payment of dividends and then out of the designated surplus. The amount regarded as having been paid out of designated surplus is limited to the amount of designated surplus on hand immediately before the payment of the taxable dividend. However, to ensure that the appropriate tax is paid in respect of all distributions of designated surplus, the Act provides that, in the event of an amalgamation between a controlled corporation and the controlling corporation, the controlling corporation is deemed to have received a taxable dividend out of the controlled corporation's designated surplus in an amount equal to its share of such designated surplus.

4.028 The amount of a corporation's earnings in the control period available for the payment of dividends is the amount of its earnings calculated for the period from the commencement of the taxation year in which control was acquired to the end of the taxation year in which the dividend was paid. In general, control period earnings include the corporation's income for taxation years in the period, net of any losses incurred and income taxes paid. The after-tax investment income of private corporations accumulated after 1971 and prior to the date of acquisition is also included in control period earnings since it is not intended that such income be subject to the special tax on designated surplus distributions. The amount of earnings in the control period at any particular time is computed after deducting any taxable dividends previously paid out of control period earnings. The detailed formula for the calculation of control period earnings is set out in paragraph 4.031.

4.029 The amount of a corporation's designated surplus is computed in much the same manner as under the old Act. There are, however, a number of important changes in the calculation which can be summarized as follows:

(a) The amount of the corporation's pre-1950 undistributed income is not included in designated surplus. This is consistent with the inclusion of such amounts in the corporation's 1971 capital surplus on hand (see paragraph 1.100).

(b) The after-tax investment income of private corporations accumulated after 1971 but before control of the corporation was acquired is not included in designated surplus. (As mentioned above, it is not intended that such income be subject to the special designated surplus tax.)

(c) The amount of designated surplus may be reduced by the amount of 1971 undistributed income on which Part IX tax has been paid to the extent that such amount exceeds pre-1972 control period earnings.

(d) Certain taxable dividends received by a parent corporation from its subsidiaries are included in the parent corporation's designated surplus. For the purpose of determining the amount to be so included, the parent company is assumed to have acquired control of the subsidiary at the time control of the parent was acquired. Generally, taxable dividends paid by the subsidiary that would have been paid out of its designated surplus based on this assumption, while not subject to the designated surplus tax in the hands of the parent, are included in the parent corporation's designated surplus and not in control period earnings. This provision is designed to ensure that where a corporation acquires control of a parent company, the pre-acquisition surplus of both the parent company and its subsidiaries are subject to Part VII tax, but only when distributed to the top corporation.

4.030 In addition to the provisions noted above, special rules are applicable in calculating the designated surplus of a new company formed as a result of a statutory amalgamation. These rules are as follows:

(a) Where the new corporation is controlled after the amalgamation by the same corporation that controlled one or more of the predecessor corporations, the designated surplus of those pre-

decessor corporations is added in determining the designated surplus of the new company.

(b) Where the amalgamation involves one or more predecessor corporations which were not controlled by the same corporation which controls the new corporation, the amount which would have been the designated surplus of those predecessor corporations, had control thereof been acquired immediately before the amalgamation, is added in determining the designated surplus of the new corporation.

(c) Where control of the new company changes hands after the amalgamation, the amount referred to in (b) above is calculated for each predecessor corporation and added to the designated surplus of the new company.

Calculation of Control Period Earnings

4.031 The amount of a corporation's earnings for a control period that is available for the payment of dividends is the aggregate of

(a) where control of the corporation was acquired prior to the end of its 1971 taxation year, the amount of control period earnings to the end of the corporation's 1971 taxation year as calculated under the old Act, less the amount on which the corporation has elected to pay Part IX tax (where tax-paid undistributed surplus has been created it is considered first to have come from pre-system control period earnings and then from designated surplus),

(b) the corporation's incomes for taxation years ending after 1971 that are in the control period,

(c) 2 times the amount of the corporation's refundable dividend tax on hand at the commencement of the control period (this amount is roughly equal to the after-tax investment income of private corporations accumulated prior to acquisition—it is not intended that such income be subject to the special designated surplus tax), and

(d) any dividend refunds for taxation years ending after 1971 that are in the control period (this is an offset to the taxes paid which are deducted below),

less the aggregate of

(e) federal, provincial and foreign taxes paid in respect of taxation years ending after 1971 that are in the control period, except foreign taxes paid which were deductible in computing income,

(f) the corporation's net capital losses, non-capital losses and restricted farm losses for taxation years ending after 1971 that are in the control period other than losses incurred in the first taxation year in the control period (losses incurred in the first taxation year are not deducted since they may be absorbed against income in the last taxation year before control was acquired),

(g) all taxable dividends paid by the corporation in the control period after 1971 to the extent that they were not paid out of designated surplus,

(h) dividends paid or deemed paid in the control period and in the corporation's 1972 taxation year but before 1972,

(i) where the control period commenced after 1971, all taxable dividends received by the corporation in the control period from subsidiaries resident in Canada and controlled by it to the extent that those dividends were not paid out of designated surplus but would have been had the designated surplus been computed as if the corporation had acquired control of the subsidiaries at the time control of the corporation was acquired. (Dividends received from a subsidiary's surplus on hand at the date on which control of the corporation was acquired are included in designated surplus rather than control period earnings—this is to ensure that the surplus of a corporation and all of its subsidiaries at the date of a change in control of the corporation are subject to the special designated surplus tax when distributed to the person who acquired control of the corporation.)

Calculation of Designated Surplus

4.032 Depending on the date on which control of the corporation was acquired, the amount of a corporation's designated surplus at a particular time is determined by one of two calculations, as follows:

1. Where control of the corporation was acquired before the end of the corporation's 1972 taxation year, the designated surplus is the aggregate of

(a) the lesser of

(i) the amount of the corporation's designated surplus determined at the end of 1971 under the provisions of the old Act less the aggregate of:

A. the amount of the corporation's tax-paid undistributed income on hand at the commencement of the control period,

B. any amount upon which the corporation has elected to pay the special 15% tax under Part II of the old Act after the commencement of the control period but before 1972, and

C. the amount of any dividends paid out of designated surplus in the control period but before 1972, and

(ii) the amount by which

A. the corporation's undistributed income on hand at the end of 1971 as calculated under the provisions of the old Act from 1950 to the end of the corporation's 1971 taxation year and adjusted for dividends received by it and paid by it after the end of its 1971 taxation year but before 1972—less the amount of the corporation's tax-paid undistributed income at the end of 1971 calculated under the provisions of the old Act exceeds,

B. the amount of the corporation's control period earnings at the end of 1971 calculated under the provisions of the old Act, and

(b) where control of the corporation was acquired after 1971, but before the end of the corporation's 1972 taxation year, all taxable dividends received after 1971 by the corporation in the control period from subsidiaries resident in Canada and controlled by it to the extent that those dividends were not paid out of designated surplus, but would have been, had the designated surplus been computed as if the corporation had acquired control of the subsidiaries at the time control of the corporation was acquired (this is the corollary to the adjustment explained in paragraph 4.031 relating to the computation of control period earnings—this amount is included in designated surplus to ensure that the surplus of a corporation and all of its subsidiaries at the date of a change in control of the corporation are subject to the special designated surplus tax when distributed to the person who acquired control of the corporation),

less the aggregate of

(c) any amount on which the corporation has elected to pay Part IX tax less the amount of control period earnings in (c) above (where tax-paid undistributed surplus has been created it is considered first to have come from pre-system control period earnings and then from designated surplus),

and

(d) all taxable dividends paid after 1971 out of designated surplus.

2. Where control of the corporation was acquired after the end of the corporation's 1972 taxation year, the designated surplus is the aggregate of

(a) the corporation's 1971 undistributed income on hand at the particular time (see paragraph 1.112),

(b) the amount of the corporation's post-1971 undistributed surplus at the end of the taxation year before control was acquired (such amount is calculated as the amount by which the aggregate of the corporation's incomes for taxation years commencing with the 1972 taxation year and ending with the last taxation year before control was acquired exceeds the aggregate of

(i) the corporation's net capital losses, non-capital losses and restricted farm losses for those years,

(ii) expenses incurred by the corporation in those years which were not allowed as deductions in computing income

(this includes such things as income tax paid and charitable donations),

(iii) taxable dividends paid in those years, and

(iv) the amount of each premium paid on the redemption of any of the corporation's capital stock, which amount was subject to tax under Part II, (such amounts are considered the equivalent of dividends),

and

(c) taxable dividends received from subsidiaries as described in 1(b) above,

less the aggregate of

(d) the amount of any negative undistributed income as calculated under the provisions of the old Act from 1950 to the end of the 1971 taxation year,

(e) dividends received by the corporation in its 1972 taxation year but before 1972 (this adjustment is required since such amounts are included in both (a) and (b) above),

(f) 2 times the amount of the corporation's refundable dividend tax on hand at the end of the last taxation year before control was acquired (this amount is roughly equal to the after tax investment income of a private corporation—it is not intended that such income be subject to the special designated surplus tax), and

(g) all taxable dividends paid after 1971 out of designated surplus.

Chapter 5

ROLLOVERS AND REORGANIZATIONS

5.001 The general rule under the Act is that a capital gain or loss must be recognized for tax purposes in the year it is realized by the taxpayer. However, in certain circumstances where a taxpayer's economic interests in a capital property remain unchanged, a deferral of any capital gain is permitted until the time of disposal of the property received in exchange. Where such a deferral is permitted, it is commonly called a "rollover". Basically, the effect of a "rollover" is that the cost of the property transferred becomes, wholly or partly, the cost of the property received by the transferor and any gain on the disposal of the property transferred is deferred until the disposal of the property received.

5.002 The four types of "rollovers" for which special rules are provided in the Act are

(a) transfer of property to a Canadian corporation,

(b) reorganizations,

(c) amalgamations, and

(d) winding up of a wholly-owned subsidiary.

It should be noted that the ordinary rules in the Act relating to non-arm's length transactions, inadequate consideration, and realization of capital gains apply to transactions where the "rollover" provisions of the Act do not apply.

TRANSFER OF PROPERTY TO A CANADIAN CORPORATION

5.003 Where a taxpayer transfers capital property or eligible capital property (generally goodwill) to a Canadian corporation, the Act provides for a deferral of the gain to the extent that the taxpayer receives shares of the corporation in exchange. The conditions which must be met in order that these "rollover" provisions may be utilized are

(a) immediately after the transfer, the taxpayer must own at least 80% of the issued shares of each class, and

(b) the taxpayer and the corporation must have jointly elected in the prescribed form and within the prescribed time to have the "rollover" rules apply.

The transferor may be an individual, a partnership, or a corporation. Accordingly the incorporation of proprietorships and partnerships and transfers to subsidiaries are the usual types of transactions to which the "rollover" provisions apply.
85(1)

General Rules

5.004 In determining the tax consequences of electing the "rollover" treatment on the transfer of capital assets to a Canadian corporation, the general rules outlined in paragraphs 5.004a to 5.009 below are applicable.

5.004a The proceeds of disposition of the property to the taxpayer, and the cost of the property to the corporation, is the amount agreed upon in the election. Assume the following for purposes of illustration:

Cost of land....................	$2,500
Fair market value of land.........	5,000
Agreed upon price in the election (deemed proceeds of disposition).	2,500

The land is deemed to have been disposed of for $2,500. There is no gain to the taxpayer, and the corporation is deemed to have acquired the land for $2,500.
85(1) (a)

5.005 Where only common shares are received in exchange, the cost of the common shares is the amount agreed upon in the election. In the above illustration, the cost of the shares to the taxpayer would be $2,500.
85(1) (h)

5.006 Where common shares and cash are the consideration received by the taxpayer, the cost of the common shares is the deemed proceeds of disposition (agreed upon price) less the cash. Assuming in the above illustration, cash of $1,200 and common shares were exchanged for the land, the cost of the common shares would be

Deemed proceeds of disposition....	$2,500
Cash received....................	1,200
Cost of common shares..........	$1,300

85(1) (h)

5.007 Where common shares and other property (but not shares of the corporation) are received by the taxpayer, the cost of the common shares is the deemed proceeds of disposition less the fair market value of the other property. Assuming $800 of other property and common shares were exchanged for the land, the cost of the common shares would be

Deemed proceeds of disposition....	$2,500
Less fair market value of other property received..............	800
Cost of common shares...........	$1,700

The fair market value of the other property ($800) is deemed to be the proceeds of disposition to the corporation and cost to the taxpayer of the other property.
85(1) (h), 85(1) (f)

5.008 Where common shares and preferred shares are received by the taxpayer, the cost to the taxpayer of the preferred shares is the lesser of their fair market value or the deemed proceeds of disposition. The cost of the common shares is the deemed proceeds of disposition less the cost to him of the preferred shares as determined above. If preferred shares with a fair market value of $1,100 and common shares were exchanged for the land, the cost of the common shares would be

Deemed proceeds of disposition....	$2,500
Less fair market value of preferred shares........................	1,100
Cost of common shares...........	$1,400

85(1) (g), 85(1) (h)

5.009 Where common shares, preferred shares, and other property are received in exchange for property transferred to the corporation, then

(a) the cost of the preferred shares is the lesser of
  (i) the fair market value of the preferred shares, and
  (ii) the deemed proceeds of disposition less the fair market value of the other property, and

(b) the cost of the common shares is the deemed proceeds of disposition less the cost of preferred shares as determined above and the fair market value of other property.

If in the above illustration, preferred shares and other property with fair market values of $1,100 and $800 respectively were exchanged for the land, the cost of the preferred and common shares would be

Deemed proceeds of disposition....	$2,500
Fair market value of other property.	800
	$1,700
Cost of preferred shares (lesser of $1,100 or $1,700)........	1,100
Cost of common shares...........	$ 600

85(1) (g), 85(1) (h)

Special Rules

5.010 Special rules which apply in a number of circumstances are outlined below in paragraphs 5.011 to 5.020.

5.011 If the transfer amount elected by the taxpayer and the corporation is less than the fair market value of the consideration (other than any shares of the capital stock of the corporation) received by the taxpayer, the amount elected upon is deemed to be the fair market value of the consideration.

5.012 For purposes of illustration, assume that a taxpayer transfers property, which has a cost of $2,500 and a fair market value of $4,500, to his corporation. The taxpayer and the corporation elect that the transfer amount be $2,500. For the transferred property the taxpayer receives consideration of cash of $1,000, other property with a fair market value of $2,200, and common shares. As a result of this special rule, the amount elected upon (and the deemed proceeds of disposition) is deemed to be $3,200, rather than the $2,500 actually elected by the taxpayer and the corporation. One of the results of this rule is that a capital gain arises to the taxpayer.

Deemed proceeds of disposition....	$3,200
Cost of property transferred.......	2,500
Capital gain to taxpayer..........	$ 700

Other results of the rule are that the cost to the corporation of the property it received is $3,200, and the cost to the shareholder of the common shares is nil.
85(1) (b)

5.013 If the transfer price elected by the taxpayer and the corporation is more than the fair market value of the property transferred to the corporation, the proceeds of disposition and the cost of the property to the corporation are deemed to be the fair market value of the property. If, for example, the taxpayer and the corporation in the above illustration elected a transfer price of $6,000, the amount elected upon (and the deemed proceeds of disposition) would be deemed to be $4,500 (the fair market value of the property transferred). Thus the capital gain to the taxpayer is $2,000.

Deemed proceeds of disposition....	$4,500
Cost of the property transferred....	2,500
Capital gain to the taxpayer.......	$2,000

The cost to the corporation of the property it received is $4,500, and the cost to the shareholder of the common shares is $1,300 ($4,500 less cash of $1,000 and other property of $2,200).
85(1)(c)

5.014 If the property transferred by the taxpayer to the corporation is depreciable property of a prescribed class, the elected price may not be less than the least of (notwithstanding the special rules above),

(a) the undepreciated capital cost of that class,

(b) the cost to the taxpayer of the property, and

(c) the fair market value of the property.
85(1) (e)

5.015 Where the proceeds of disposition are less than the taxpayer's capital cost, then the capital cost of the property to the corporation is deemed to be the amount that was the capital cost to the taxpayer and the excess capital cost over proceeds of disposition is deemed to have been allowed to the corporation as capital cost allowance.
85(5)

5.016 For purposes of illustration, assume that a taxpayer transfers all of the property of a class to a corporation in which he owns all the shares.

	Case 1	Case 2
Capital cost of property........	$9,800	$9,800
Undepreciated capital cost of class......................	4,300	4,300
Fair market value of property..	5,200	3,500
Elected amount..............	4,000	3,000
Capital cost to corporation.....	9,800	9,800
Deemed proceeds of disposition to taxpayer................	4,300	3,500
Amount deemed to have been allowed to corporation as capital cost allowance.......	5,500	6,300
Terminal loss to taxpayer......	NIL	800

5.017 If the property transferred is eligible capital property, the rules are similar to those above for depreciable property except that the phrase "the undepreciated capital cost of that class" should be replaced by the phrase "2 times the cumulative eligible capital in respect of the business".
85(1) (d)

Partnerships

5.018 The above rules apply where a partnership transfers capital property or eligible capital property to a Canadian corporation if

(a) immediately after the transfer at least 80% of the issued shares of each class of the corporation's capital stock is partnership property, and

(b) the corporation and all members of the partnership have jointly elected to have the "rollover" rules apply.
85(2)

5.019 In addition, if the partnership has qualified under (a) and (b) above and

(c) the affairs of the partnership are wound up within 60 days of the transfer in (a), and

(d) immediately before the winding-up of the partnership, the only property of the partnership is money or property received from the corporation as consideration for the transfer,
85(3)

the gain on the partners' disposition of their partnership interest may be deferred in accordance with certain rules. The effect of these rules is that the adjusted cost base of a partner's interest may be, wholly or partly, rolled over into the cost of shares of the corporation which are received by the various partners on the winding-up. In order to have these special rules apply, a prescribed election form must be filed for the year in which the partnership is wound up, and must be signed by both the transferor and the transferee. The rules are as follows:

(1) The deemed cost to any member of the partnership of property (other than shares of the corporation or rights to receive such shares) received by him on the winding-up is the fair market value of such property at the time.

(2) The deemed cost to any member of any preferred shares received by him in exchange for his partnership interest on the winding-up is the adjusted cost base of his partnership interest less the deemed cost of any property referred

to in (1) above. If common shares are received in addition, the deemed cost of the preferred shares is limited to their fair market value.

(3) The deemed cost to any member of any common shares received by him on the winding-up is the adjusted cost base of his partnership interest less the deemed cost of any property referred to in (1) above and less the deemed cost of the preferred shares referred to in (2) above.

Loss Restrictions

5.020 Where a taxpayer transfers any capital property to a corporation that, immediately after the transfer, is controlled by the taxpayer in any manner whatever, the Act provides that

(a) any capital loss incurred by the taxpayer as a result of the transfer will not be deductible,

(b) the amount of any capital loss disallowed shall be added to the adjusted cost base of any common shares owned by the taxpayer immediately after the transfer, and

85(4)

(c) where the taxpayer owned no common shares of the corporation immediately after the disposition, the amount of any capital loss disallowed shall be added to the adjusted cost base of any preferred shares owned by the taxpayer immediately after the disposition.

It should be noted the loss restrictions referred to above will apply regardless of whether or not the rollover rules have been elected.

REORGANIZATIONS

5.021 Where, in the course of a reorganization of the capital of a corporation, a shareholder has disposed of shares of the capital stock of the corporation to the corporation, the Act provides for a deferral of any gain on the transaction in the following circumstances and with the following results:

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(1) Where the shareholder receives only shares of the capital stock of the corporation in exchange for the shares disposed of, there is no gain to the shareholder and the adjusted cost base of the shares disposed of becomes the adjusted cost base of the shares received.

(2) Where the shareholder receives shares and other consideration, the value of the other consideration reduces the adjusted cost base of the shares received.

(3) There is a gain to the shareholder to the extent that the value of the other consideration exceeds the adjusted cost base of the shares disposed of.

Examples

5.022 Assume that a shareholder owns common shares of a corporation. The shares have an adjusted cost base of $1,200 and a fair market value of $3,000. The corporation reorganizes its share capital and, in the course of the reorganization, the corporation acquires the old common shares under the conditions stated in Examples 1 to 4 below.

Example 1

The shareholder receives common shares only.

Proceeds of disposition of old common shares	$1,200
Adjusted cost base of old common shares	1,200
Gain to shareholder	Nil
Cost of new common shares	$1,200

Example 2

The shareholder receives common shares and cash of $500 (Case 1) and $1,500 (Case 2).

	Case 1	Case 2
Cost of new common shares is—		
Adjusted cost base of old common shares	$1,200	$1,200
Cash received	500	1,500
Cost of new common shares	$ 700	Nil
Proceeds of disposition of old common shares		
Cost of new common shares	$ 700	$ Nil
Cash received	500	1,500
Proceeds of disposition of old common shares	$1,200	1,500
Adjusted cost base of old common shares	1,200	1,200
Gain to shareholder	$ Nil	$ 300

Example 3

The shareholder receives common shares, and preferred shares having a fair market value of $650 (Case 1) and $1,350 (Case 2).

	Case 1	Case 2
Cost of preferred shares is lesser of—		
(a) fair market value of preferred shares	$ 650	$1,350
(b) adjusted cost base of old common shares less consideration other than shares	$1,200	$1,200
Cost of new common shares is		
Adjusted cost base of old common shares	$1,200	$1,200
Less—Cost of preferred shares	650	1,200
	$ 550	$ Nil
Proceeds of disposition of old common shares		
Cost of preferred shares	$ 650	$1,200
Cost of new common shares	550	Nil
Proceeds of disposition of old common shares	$1,200	$1,200
Adjusted Cost base of old common shares	1,200	1,200
Gain to shareholder	$ Nil	$ Nil

Example 4

The shareholder receives common shares, preferred shares having a fair market value of $650, and other property having a fair market value of $830 (Case 1) and $1,420 (Case 2).

Cost of preferred shares is lesser of—	Case 1	Case 2
(a) fair market value of preferred shares	$ 650	$ 650
(b) excess, if any, of adjusted cost base of old common shares over fair market value of the other property	370	Nil
Cost of new common shares is		
Adjusted cost base of old common shares	$1,200	$1,200
Less: Cost of preferred shares	$ 370	$ Nil
Cost of other property (fair market value)	830	1,420
	$1,200	$1,420
Cost of new common shares	$ Nil	$ Nil
Proceeds of disposition of old common shares		
Cost of preferred shares	$ 370	$ Nil
Cost of new common shares	Nil	Nil
Cost of other property	830	1,420
Proceeds of disposition of old common shares	$1,200	$1,420
Adjusted cost base of old common shares	1,200	1,200
Gain to shareholder	$ Nil	$ 220

Notes

(a) In these examples the terms "common share" and "preferred share" are interchangeable.

(b) The rules for reorganizations do not apply where the rules for transfer of assets to Canadian corporations apply.

(c) In applying the reorganization rules, the provisions concerning deemed dividends discussed in Chapter 4 should be considered. The amount of a deemed dividend on a reorganization could affect the amount of a shareholder's gain or loss on the transaction. For the purposes of the above examples, it is assumed that there were no deemed dividends.

AMALGAMATIONS

5.023 The new Act contains special rules for amalgamations which occur after December 31, 1971. These rules are basically unchanged from the old Act except that additional rules have been added to deal with new terms in the new Act.

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5.024 An amalgamation is defined as a merger of two or more corporations (called "predecessor corporations"), each of which was, immediately before the merger, a Canadian corporation, to form one corporate entity (called the "new corporation") in such manner that

(a) all of the property of the predecessor corporations immediately before the merger becomes property of the new corporation by virtue of the merger,

(b) all of the liabilities of the predecessor corporations immediately before the merger become liabilities of the new corporation by virtue of the merger, and

(c) all of the shareholders (except any predecessor corporations) of the predecessor corporations immediately before the merger become shareholders of the new corporation by virtue of the merger,

otherwise than as a result of

(d) the acquisition of property of one corporation by another corporation, pursuant to the purchase of such property by the other corporation, or

(e) the distribution of such property to the other corporation upon the winding-up of the corporation.

Where, immediately before the amalgamation, one of the predecessor corporations owned any shares of the capital stock of another predecessor corporation, any excess of the paid-up capital in respect of the owned shares over the adjusted cost base of the shares to the owner corporation is added to the new corporation's paid-up capital deficiency.

Rollovers

5.025 Shareholders of predecessor corporations (except a predecessor corporation) are allowed to roll over the cost of their shares in the predecessor corporations to their shares in the new corporation (thus deferring any capital gain on the amalgamation) in circumstances where

(a) a preferred shareholder of a predecessor corporation receives, in exchange for his preferred shares, only preferred shares of the new corporation having substantially the same rights and conditions attaching thereto as attached to the preferred shares disposed of (determined without regard to any voting rights attaching to any shares),

(b) either

(i) a shareholder was a common shareholder of a predecessor corporation, and

(1) none of the persons (except any predecessor corporation) who owned any of the common shares of that predecessor corporation receives consideration other than shares in the capital stock of the new corporation, and

(2) the common shareholders (except any predecessor corporation) of the predecessor corporation received as proceeds of the disposition of those shares on the amalgamation not less than 25% of each class of the issued common shares of the new corporation, or

(ii) a shareholder was a common shareholder of more than one predecessor corporation, and

(1) none of the persons (except any predecessor corporation) who owned any of the common shares of those predecessor corporations receives consideration other than shares in the capital stock of the new corporation, and

(2) the shareholder received as proceeds of the disposition of his common shares of the predecessor corporations on the amalgamation not less than 80% of each class of the issued common shares of the new corporation.

Mechanics

5.026 The Act sets out a number of rules, many of which are the same as or similar to rules under the old Act, dealing with such things as the taxation year of the new corporation, inventory, method of computing income, depreciable property, reserves, debts, special reserves, certain payments to employees, scientific research, charitable donations, and losses.

5.027 A number of new items, like many of the above items, have the balances in each of the predecessor corporations added together to produce opening balances for the new corporation. These items include capital property (other than depreciable property), cumulative eligible capital, tax-paid undistributed surplus on hand, 1971 capital surplus on hand, paid-up capital deficiency, 1971 undistributed income on hand, cumulative deduction account, refundable dividend tax on hand, preferred-rate amount, allowable refundable tax on hand for non-resident-owned investment corporations, and capital gains dividend account of mutual fund corporations. A brief description of the rules as they apply to the cumulative deduction account, 1971 capital surplus on hand, and paid-up capital deficiency appears below.

Cumulative Deduction Account—If the aggregate of the cumulative deduction accounts of the predecessor corporations are equal to or greater than $400,000, then the new corporation will not be eligible for the small business deduction unless the payment of taxable dividends has reduced such accounts to below $400,000.

1971 Capital Surplus On Hand and Paid-Up Capital Deficiency—On an amalgamation, the 1971 capital surplus on hand or the paid-up capital deficiency of each of the predecessor corporations are aggregated, and the resulting balance is the 1971 capital surplus on hand or the paid-up capital deficiency of the new corporation, as the case may be.

Designated Surplus

5.028 The rules applicable to calculating the designated surplus of an amalgamated company are dealt with at paragraph 4.030.

Foreign affiliates

5.029 Where a foreign affiliate of a predecessor corporation becomes, by virtue of the amalgamation, a foreign affiliate of the new corporation, the new corporation is deemed to have added or deducted adjustments to the adjusted cost base of the shares in the foreign affiliate that were required to be made by the predecessor corporation, and any exempt dividend received by the predecessor corporation is deemed to be an exempt dividend received by the new corporation. Further details concerning foreign affiliates may be found at paragraphs 7.021 to 7.040.

WINDING-UP OF A WHOLLY-OWNED SUBSIDIARY

5.030 The Act provides special rules where a wholly-owned subsidiary is wound up. The rules apply where:

(a) immediately before the winding-up the parent owned all of the issued shares of the subsidiary, and

(b) both the parent and subsidiary are Canadian corporations.

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Rules

1. The parent's cost (and the subsidiary's proceeds of disposition) of any property received by the parent on

winding-up is the subsidiary's cost amount of the property, except where the property is a resource property as referred to in Section 59(2) of the Act, in which case the parent's cost and subsidiary's proceeds are deemed to be nil. Where the adjusted cost base of the parent's shares in the subsidiary exceeds the cost amount of the subsidiary's property less its liabilities, the parent may designate the excess as being an increase in the price of any capital property (other than depreciable property) transferred to it. The price of any capital property (as increased by the designation) may not exceed the fair market value of that property. The amount of the designation will increase the cost of the property to the parent, but will not increase the subsidiary's proceeds of disposition. For depreciable property, the capital cost of the property to the parent is deemed to be the amount of the subsidiary's capital cost of that property and the difference between the subsidiary's capital cost and undepreciated capital cost ("cost amount") is deemed to have been allowed to the parent as capital cost allowance.

2. No gain will accrue to the subsidiary on disposal of its property (to the extent the property is rolled over to its parent corporation).

3. In such a winding-up, there is a deemed disposition of the parent's shares in the subsidiary. No gain will accrue to the parent on disposition of shares in the subsidiary, except where the adjusted cost base of the parent's shares in the subsidiary is less than the least of:

(a) the subsidiary's paid-up capital limit, or

(b) the cost amount of the subsidiary's property plus the amount of any money of the subsidiary on hand immediately before the winding-up.

Chapter 6

SPECIALTY CORPORATIONS

MINING AND PETROLEUM

6.001 There are a number of significant changes in the taxation of income from mineral and petroleum properties to be effected over a period of years. These changes concern,

(a) the method of computing depletion,

(b) the inclusion in income of proceeds of sale of mineral properties and deductibility of the cost of such properties,

(c) the expanded deductibility of exploration and development expenses within specified limits for corporations whose principal business is not mining and petroleum, and expansion of deductibility of foreign exploration and development expenses for all taxpayers,

(d) removal of three year exemption from tax on income from a new mine to be replaced by an accelerated amortization of the cost of certain assets acquired for a new mine or a major expansion of an existing mine,

(e) introduction of an abatement of federal tax of 15% on mining profits coupled with the removal of the deductibility of provincial mining taxes, and

(f) removal of exemption from tax for prospectors and grubstakers.

6.002 It should be noted that, at the time of writing, regulations had not been issued indicating how the above changes are to be implemented but a News Release issued by the Department of Finance sets out the general provisions to be contained in such regulations. The following comments are based on this News Release. It is important that the reader refer to the official regulations when considering the taxation of mining and petroleum income.

Depletion

6.003 At the present time operators and non-operators of mining and petroleum properties are allowed an automatic percentage depletion which is deductible from income earned from such properties. The percentage depletion allowed to operators is generally $33\frac{1}{3}\%$ of net production profits, and to non-operators it is 25% of the gross revenue received from such properties. These provisions will continue to apply until the end of 1976 at which time such depletion will be limited to the lesser of $33\frac{1}{3}\%$ of net production profits or $33\frac{1}{3}\%$ of "accumulated eligible expenditures". In the case of royalty interest of non-operators, such depletion will be based on income from royalties rather than on net production profits.
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6.004 The system of depletion introduced is known as "earned depletion" which differs from the present method of automatic percentage depletion in that it is necessary to incur "eligible expenditures" listed below in order to obtain depletion. Presently, automatic percentage depletion is based on production profits regardless of such expenditures being incurred. Commencing after 1976, depletion will be permitted at a maximum rate of $33\frac{1}{3}\%$ of income derived from mining and petroleum properties, and royalty interests, but any allowance for depletion must be "earned" by incurring eligible expenditures. For every $3 of eligible expenditures incurred after November 7, 1969, a taxpayer will earn the right to $1 of depletion. The amount of automatic percentage depletion claimed in the period up to the end of 1976 will not affect the amount of depletion earned from eligible expenditures made in that period.

The News Release indicates that "eligible expenditures" will include

(a) drilling and exploration expenses incurred in exploring or drilling for petroleum or natural gas in Canada,

(b) prospecting, exploration and development expenses incurred in searching for minerals in Canada,

(c) expenditures on buildings (except an office building not situated on the mine property), machinery and equipment (including electrical, generating or distributing equipment and plant) relating to a new mine, if made prior to the mine coming into production, or to a major expansion of an existing mine which results in at least a 25% increase in productive capacity

of the mine mill, if made before the commencement of production at the higher level of capacity, and,

(d) expenditures on new buildings and machinery to the extent they are to be used to process ore from Canadian mineral resources beyond the stage to which they were previously processed in Canada but not beyond the prime metal stage or its equivalent.

It should be noted that "eligible expenditures" will not include the cost of resource properties, interest expense which the taxpayer has elected to be treated as exploration and development expenses, community and transportation facilities relating to the operation of a mine, foreign drilling, exploration and development expenses, depreciable property relating to an oil or gas well, and exploration and development expenses in the vicinity of a mine after it came into production.

6.005 It is also proposed that where there has been a statutory amalgamation of mining or petroleum corporations, or where a mining or petroleum corporation has taken over all or substantially all of the resource property of another such corporation, earned depletion of a predecessor corporation which has not been absorbed against its production income may be assumed by the continuing corporation to be claimed against production income from the properties which were taken over.

6.006 The definition of net production profits for purposes of the "earned depletion" calculation will be similar to that presently provided under the regulations for determining automatic percentage depletion except that royalties from Canadian resources not operated by the taxpayer will also be included in the definition.

Example 1 illustrates how this provision will operate:

Example 1

Assume	1977	1978	1979
A Net production profits (no other income)	$1,200,000	$1,500,000	$1,800,000
B Eligible expenditures (amounts incurred prior to 1977—$1,500,000)	300,000	300,000	300,000

Computation of Allowable Depletion and Taxable Income			
Net production profits	1,200,000	1,500,000	1,800,000
Less: Earned depletion—33⅓% lesser of:			
A Production profits	400,000	500,000	600,000
B Earned depletion base	600,000	300,000	100,000
Taxable income	$ 800,000	$1,200,000	$1,700,000

Calculation of Earned Depletion base (Eligible expenditures-gross)

	Additions for the year	Claimed for the year	Balance
Prior to 1977			$1,500,000
1977—Additions	300,000		1,800,000
—Allowed X3		$1,200,000	600,000
1978—Additions	300,000		900,000
—Allowed X3		900,000	—
1979—Additions	300,000		300,000
—Allowed X3		300,000	—

6.007 The above example illustrates that where there is adequate earned depletion base available, only 33⅓% of net production profits may be claimed as earned depletion for the year. However, where net production profits exceed the amount of earned depletion base available, only 33⅓% of the earned depletion base amount available may be claimed as earned depletion. The earned depletion base account is kept on a gross basis (eligible expenditures), and is reduced by 3 times the earned depletion claimed after 1976. As illustrated in the example for the 1977 year, any amount not claimed in the year may be carried forward to future years.

Purchase and Sale of Mineral Properties and Royalty Interests

6.008 Under the old Act, the purchase and sale of oil rights were taxable as income when sold and were deductible when purchased. This treatment has now been extended to the purchase and sale of mineral properties wherever located, and to mining and petroleum royalty interests including interests in foreign mining and petroleum properties. As a result, the sale of any such properties or interests will be taxable when such sale takes place after December 31, 1971. The cost of all such resource properties acquired after December 31, 1971, will be

deductible as exploration and development expenses. (As noted earlier, these costs will not be included as eligible expenditures for the purposes of earned depletion.)

6.009 Resource properties do not have to be valued at valuation day since the proceeds will be considered to be ordinary income and there is no "capital gain" involved which would require the determination of "cost". However, in the case of resource properties (other than oil and gas rights the proceeds of which have been taxable since 1962) that are owned on December 31, 1971, and are sold prior to 1980, transitional rules provide that only part of the proceeds from such sale are to be included in income. The percentage to be included will be 60% for sales made in 1972, and this percentage will increase 5% a year until it reaches 100% in 1980. If the purchaser is dealing at arm's length with the vendor, the purchaser will be entitled to a full deduction for his cost of such rights. However, where they are not dealing at arm's length, the purchaser will only be allowed a deduction equal to the amount that must be included in the income of the vendor.

6.010 The vendor will include the taxable proceeds from the sale of each resource property in his income for the year of sale. Where the full sale price is not receivable by the end of the taxation year he will be entitled to a reserve equal to the lesser of the amount that is not receivable or the amount included in income for the year. This reserve must be included in income of the following year and if an amount is still not receivable at the end of that year, a reserve may be deducted on the same basis.
64

6.011 The following example illustrates the mechanics of this provision:

Example 2

Assume	
Proceeds of sale of resource property—fully taxable	$50,000
Amount not receivable at end of year	$40,000
Calculation of Income	
Proceeds from sale of resource property	$50,000
Less reserve for amount not receivable	40,000
Income for the year	$10,000

If such property had been owned on December 31, 1971, and sold in 1973, only 65% of the proceeds would be included in income and the calculation would be as follows:

Example 3

Taxable proceeds—65% of $50,000		$32,500
Deduct lesser of:		
(a) amount receivable at end of year—	$40,000	
(b) amount included in income	32,500	32,500
Income for the year		Nil

6.012 The above rules for calculating reserves only apply to sale of resource properties and do not apply to the calculation of reserves where the property sold is land, buildings or accounts receivable.

6.013 The reserves discussed above cease to be allowable as a deduction in a year if the taxpayer, in that year or the immediately following year,

(1) ceased to be resident in Canada,
(2) became exempt from tax, or
(3) if a non-resident, ceased to carry on business in Canada.

In addition, where the taxpayer is a dealer in resource properties, these provisions are not applicable to him unless such taxpayer can establish that his principal business is mining or petroleum.

Exploration and Development Expenses

6.014 As under the old Act, corporations who meet the principal business test, i.e., they are engaged in mining, petroleum, and certain similar activities, continue to be entitled to deduct from income from any source the total of their Canadian exploration and development expenses to the extent of such income. As indicated above, Canadian exploration and development expenses have been expanded to include the cost of Canadian resource properties and as a result such costs will be deductible from any source of income.
66(1), ITAR 29

6.015 Other corporations were restricted under the old Act in their entitlement to deduct Canadian exploration and development costs to the extent of income from Canadian mining and petroleum interests. Under the new Act, such taxpayers will continue to be able to deduct Canadian exploration and development costs incurred prior to 1972 to the extent of income earned from Canadian mining and petroleum interests. In addition they will be allowed to deduct the lesser of:
66(3)

(a) the aggregate of their Canadian exploration and development expenses incurred subsequent to 1971 to the end of the particular taxation year to the extent they were not deductible in a previous year, and,

(b) of that aggregate, the amount by which the greater of:

(i) income from Canadian resource properties, including taxable proceeds from sale of

such properties less any reserve deducted, before deduction of depletion, if any, and,

(ii) 20% of the aggregate in (a), exceeds

(iii) the pre-1972 exploration and development costs deducted in the year.

6.016 The following examples illustrate how the provision described in paragraph 6.015 will operate:

Example 4—No exploration and development expenses incurred prior to January 1, 1972

Assume		
Exploration and development expenses—1972		$60,000
Net business income other than mining or petroleum		$80,000
Net mining or petroleum income (before exploration and development)		$10,000
Computation of taxable income—December 31, 1972		
Business income		$80,000
Mining or petroleum income		10,000
		$90,000
Less: Exploration and development expenses		
Greater of:		
(a) mining or petroleum income	$10,000	
(b) 20% of exploration and development expense (20% of $60,000)	$12,000	$12,000
Taxable income		$78,000

Example 5—Exploration and development expenses incurred prior to and subsequent to January 1, 1972

Assume			
Exploration and development expenses incurred prior to January 1, 1972			$15,000
Other facts as in Example 4			
Computation of taxable income—December 31, 1972			
Business income			$80,000
Mining or petroleum income			10,000
			$90,000
Less: Exploration and development expenses			
Pre 1972 expenses to extent of mining or petroleum income		$10,000	
Against other income			
20% of post January 1, 1972, expenses—20% of $60,000	$12,000		
Less: Pre January 1, 1972, expenses deducted above	10,000	2,000	$12,000
			$78,000

6.017 The other major change is that all taxpayers are entitled to deduct their foreign exploration and development costs to the extent of the greater of

(a) their income from foreign mineral and petroleum properties or

(b) 10% of such costs on a declining balance basis.

The costs that are deductible under this provision are those incurred since December 31, 1971.

6.018 Some features of the old act continue practically unchanged; for example, the new act provides:

(a) That where a new "principal-business corporation" is formed by amalgamation, unclaimed Canadian exploration and development expenses may be transferred to the continuing company and applied against income from Canadian properties owned by the predecessors.
87(6), 87(7)

(b) That where a "principal-business corporation" acquires substantially all of the Canadian assets of another "principal-business corporation", unclaimed Canadian exploration and development costs of the latter company may be claimed by the purchaser against income from the properties acquired.
66(6), 66(7)

(c) For a "principal-business corporation" to deduct Canadian exploration and development expenses incurred by it pursuant to an agreement which also provides that it receive shares or an interest in shares of another corporation.
66(15)

(d) That a "joint exploration company" may renounce exploration and development costs which it incurs in order that they may be claimed by its shareholding "principal-business corporations".
66(10)

6.019 The new Act contains a provision which will prohibit the carry-forward of unclaimed exploration and development costs when control of a corporation changes hands after it has ceased to carry on an active business and before it commences to carry on an active business again.
66(11)

Accelerated Write-off of Capital Expenditures

6.020 The new Act repeals the three year exemption for new mines for income earned after December 31, 1973. The three year exemption is to be replaced by provision for accelerated amortization of the cost of assets

acquired in order to put a new mine into production or for the major expansion of an existing mine.
ITAR 28

A major expansion is considered to have taken place if the productive capacity of the mine mill is increased by at least 25%.

6.021 The assets which qualify are new depreciable assets which were acquired after November 7, 1969, and prior to the mine coming into production for the purpose of gaining or producing income from the mine including income from processing mineral ores to the prime metal stage or its equivalent. The assets which qualify include

(a) buildings (except an office building not situated on the mine property),

(b) mining machinery and equipment,

(c) electrical, generating, and distributing equipment and plant for providing power to the mine where at least 80% of the power is used for that purpose for the first two taxation years, and

(d) community and transportation facilities necessary for the operation of the mine such as railroads situated on the mine property, housing, schools, hospitals, sidewalks, sewers, sewage disposal plants, roads, airports, and docks.

In the case of a major expansion of an existing mine, only the first three categories above will qualify for accelerated write-off provided they were acquired after November 7, 1969, for an expansion which took place after that date, but prior to the commencement of production at the higher level of capacity.

6.022 The provisions for accelerated write-offs require that the assets for *each mine* be set up in a separate class for capital cost allowance purposes, and such class may be written off in yearly amounts equal to the greater of the income from *such mine* and 30% of the undepreciated capital cost of the class. Where assets have been acquired after November 7, 1969, and prior to 1972 that would qualify under this provision, the undepreciated capital cost of such assets may be transferred to this new class from the classes in which they were.

6.023 If the taxpayer elects to claim exemption of the income of a new mine that is earned prior to 1974, he cannot also claim accelerated capital cost allowance on expenditures relating to that mine unless he reduces the undepreciated capital cost of such assets by the amount of the exempt income.

Abatement for Provincial Mining Taxes

6.024 The old Act provided for a deduction from income of provincial mining taxes. The new Act continues to allow such deduction up to the end of 1976. For taxation years ending after 1976, this provision is to be replaced by a provision allowing a deduction from tax payable equal to 15% of the taxable production profits from mineral resources. This will be in addition to the 10% abatement allowed for provincial corporation taxes.
124(2)

6.025 The above deduction, however, cannot exceed 15% of the amount by which the taxable income of the corporation exceeds the aggregate of

(1) 4 times its small business deduction and

(2) its Canadian and foreign investment income as defined for purposes of refundable dividend tax on hand. See paragraphs 2.083 to 2.094.

6.026 The definition of taxable production profits for mineral resources is to be defined by regulation and such regulation has not yet been issued. The Department of Finance has indicated that the definition of taxable production profits will include profits from mines presently eligible for percentage depletion, coal mines and tar sands deposits. It will not, however, include income from oil and gas wells, royalty income from interests in mines and oil and gas wells, or taxable proceeds from sale of mineral properties. The amount on which the abatement will be calculated will be the taxable production profits from operations indicated above less the amount of any exploration and development cost and earned depletion that might be claimed related to these profits.
N.R.

6.027 It should be noted that this abatement will be available not only to mines operating in a province but also to mines operating in the Yukon and the Northwest Territories.

6.028 As indicated earlier, this abatement will replace the present deduction for provincial mining taxes. As a result, commencing in the 1977 taxation year, no deduction for provincial mining taxes will be allowed where an abatement as indicated above is available. For 1977 taxation years that commence in the 1976 calendar year, transitional provisions are to be provided by regulation yet to be issued.

6.029 The following examples illustrate how the abatement will operate:

Example 6—Not eligible for small business deduction

Assume

Mining income after all expenses except provincial mining tax		$15,000
Earned depletion available		$ 5,000
Provincial mining taxes		$ 2,250

Computation of taxable income	1972	1977
Mining income	$15,000	$15,000
Deduct provincial mining taxes	$ 2,250	
Taxable production profits	$12,750	$15,000
Depletion	$ 4,250	$ 5,000
Taxable income	$ 8,500	$10,000
Computation of tax		
Part I rates—1972—50%, 1977—46%	$ 4,250	$ 4,600
Deduct: Provincial tax abatement	$ 850	$ 1,000
Mining tax abatement		$ 1,500
	$ 850	$ 2,500
Federal tax payable	$ 3,400	$ 2,100

Example 7—Eligible for the small business deduction

Assume

Mining income after all expenses					$15,000
Earned depletion available					5,000
Canadian interest income					2,000
Provincial mining tax					2,250
Computation of taxable income					
Mining income					$15,000
Canadian interest income					2,000
					17,000
Less depletion					5,000
Taxable income					$12,000
Computation of tax					
Tax at 46%					$ 5,520
Less: Provincial tax abatement—10% of $12,000				$ 1,200	
Small business deduction—21% of $10,000				2,100	
Mining tax abatement—lesser of:					
(a) Taxable production profits			$10,000		
(b) Taxable income		$12,000			
Less: 4 times small business deduction—4 × $2,100	$8,400				
Canadian interest income	2,000	10,400	1,600		
15% of lesser of (a) and (b)—15% of $1,600				240	3,540
Federal tax payable					$ 1,980

Prospectors and Grubstakers

6.030 The exemption from tax on income earned by prospectors and grubstakers in respect of the sale of mining properties or shares received in respect of such property is to be removed effective January 1, 1972. In the case of prospectors and grubstakers they will not be taxed on the proceeds from sale of mineral properties to a corporation when they receive shares in exchange for such properties. In such circumstances, the shares will be deemed to have no cost base for capital gains tax purposes and as a result they will be taxable on the proceeds resulting from the sale of such shares under the capital gains tax provisions. In addition the corporation purchasing such properties in the above circumstances will be deemed to have acquired such properties at no cost.

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MUTUAL FUNDS AND INVESTMENT CORPORATIONS

6.031 The old Act previously permitted an investment corporation to pay the low rate of tax on all its taxable income subject to meeting certain terms relating to nature of assets, income, and distribution of the earnings of the corporation.

6.032 The corporation was a means of pooling investment funds and passing a high percentage of its yearly earnings on to its shareholders in the form of dividends. The new Act continues the "conduit" concept but now visualizes this concept in the following three categories of corporations and trusts as defined in the Act:

(A) Investment Corporations
(B) Mutual Fund Corporations
(C) Mutual Fund Trusts

(A) Investment Corporations

6.033 A corporation was an investment corporation throughout any taxation year if it met the following requirements:

(1) it was throughout the year a Canadian corporation that was a public corporation,

130(3)

(2) at least 80% of the property of such a corporation throughout the taxation year consisted of shares, bonds, marketable securities or cash,

(3) not less than 95% of the income for the year was derived from property listed in (2) above, and gains on disposal of shares, bonds and marketable securities are to be included in arriving at the 95% level of income from such assets,

(4) at least 85% of gross revenue was from sources in Canada,

(5) not more than 25% of gross revenue for the year was from interest,

(6) at no time in the year did more than 10% of the property of the corporation consist of shares, bonds or securities of any one corporation or debtor other than those of a provincial, municipal or federal government,

(7) no shareholder of the corporation held more than 25% of the issued shares of the capital stock of the corporation,

(8) there was distributed to the shareholders at least 85% of the total of its exempt dividends and its taxable income, excluding taxed capital gains and after deducting tax paid ("taxed capital gains" means taxable capital gains for the year minus allowable capital losses of that year or another year which are deductible in the year in computing taxable income).

Taxability

6.034 Corporations which qualify as investment corporations under the Act are taxable in the same manner as public corporations, except that the rate of tax, on taxable income other than taxable capital gains, is 25 percentage points less than normal public corporation rates.

130(1)

6.035 Taxable capital gains of an investment corporation are taxed at normal corporate tax rates under Part I of the Act. The major difference in the case of an investment corporation is that the federal tax on capital gains is refundable when it distributes the capital gains to its shareholders. For these distributions an investment corporation must file an election and pay a capital gains dividend.

6.036 To summarize, the applicable rate of tax for an investment corporation is as follows:

	1972	1973	1974	1975	1976
On taxable capital gains (federal tax is refundable to a qualified investment corporation)	50%	49%	48%	47%	46%
On "other taxable income"	25%	24%	23%	22%	21%

Example

6.037 To illustrate, assume an investment company has the following operating results for the year ended December 31, 1972:

Taxable Canadian corporation dividends			$3,000
Interest and other taxable income (net)			1,000
Capital gains total-net after expenses		$200	
½ tax exempt		100	100
Net income			4,100
Less: Taxable Canadian dividends			3,000
Taxable income			$1,100
Tax on taxable income (Part I) at 50%			550
Less: Provincial tax abatement at 10%		$110	
Tax reduction on income other than taxed capital gains			
Taxable income	$1,100		
Less: Taxed capital gains	100		
	$1,000 at 25%	250	360
Total Tax-Federal			$ 190

The total federal tax above includes $40 refundable capital gains tax.

6.038 If the corporation were to disburse all or a part of its capital gains as a "capital gains dividend" by electing in the prescribed manner, the corporation then could obtain a refund of the federal capital gains tax. The amount of the refund is determined by multiplying the total capital gains dividend (assume $200) by 20% which in this example results in a refundable tax of $40. If there is not that much "refundable capital gains tax on hand", the refund would be limited to the amount available.
130(2), 131(1), 131(2)

Shareholders
6.039 In order to continue the conduit principle, the shareholder receiving a capital gains dividend is deemed to have received a capital gain and must report it in the prescribed manner for an individual or a corporation receiving a capital gain.
131(1) (b)

6.040 Ordinary dividends (i.e. dividends other than capital gains dividends) received from an investment corporation will be treated as normal dividends, and for an individual this means normal gross up and credit. The redemption of shares by an investment corporation under the Act are subject to the usual deemed dividend rules discussed in Chapter 4.

(B) Mutual Fund Corporations
6.041 Mutual fund corporations are commonly classified as "open-end", or "closed-end" corporations. The term "open-end" refers to the method by which the corporation's shares can be redeemed daily at market value. If the shares ordinarily can be bought only from existing shareholders, or must be sold to other persons (not redeemable), the corporation is referred to as "closed-end". Because of the following definition, the only type of corporation that is recognized as a mutual fund under the Act is an open-end mutual fund corporation.

6.042 In general, under the Act a corporation is a mutual fund corporation at any time in a taxation year if at that time

(a) it was a Canadian corporation that was a public corporation,

(b) its only undertaking was the investing of funds of the corporation, and

(c) it had 95% of the fair market value of all its outstanding shares of capital stock in redeemable form, in order that redemption might occur at the request of the shareholder.

131(8)

6.043 Mutual fund corporations as defined under the Act can be placed in one of two categories—

(1) those mutual fund corporations which meet the conditions of investment corporations, (see paragraph 6.033)

(2) those mutual fund corporations which cannot qualify as investment corporations.

Mutual Fund Corporations Which Also Qualify as Investment Corporations
6.044 A mutual fund corporation which qualifies as an investment corporation is taxed much like any other investment corporation. The example under the heading "Investment Corporations" is applicable to a corporation which so qualifies (i.e. dividends from taxable Canadian corporations are exempt; other investment income qualifies for the 25 percentage points reduction in the normal corporate rate; realized capital gains will be taxed at normal corporate Part I rates and such tax is refundable when the gains are distributed to shareholders as capital gains dividends; Part IV tax does not apply). In addition to the taxation features of an investment corporation, a mutual fund corporation may be eligible for a refund of capital gains tax through the redemption of its shares at the request of its shareholders. This results in a realized capital gain taxable in the shareholder's hands.

6.045 The "capital gains redemptions" formula applicable to the recovery of capital gains tax of a mutual fund corporation operates as follows:

$$\frac{\text{Amount paid for redemption in year}}{\text{Amount paid for redemption in year plus fair market value of all outstanding shares at the year-end}} \times \text{Five times Refundable Capital Gains Tax on hand plus unrealized capital gains of the Mutual Fund}$$

6.046 For mutual fund corporations with fiscal periods ending in 1972, only redemptions after January 1, 1972, are taken into account for the purposes of the formula.

6.047 The amount of capital gains refund to be recovered by the mutual fund is the lesser of

(1) 20% of all capital gains dividends paid in the year and the result of the "capital gains redemptions" formula for the year (see above), and

(2) the "refundable capital gains tax on hand" at the end of the year (see below).

6.048 The amount of the "refundable capital gains tax on hand" at the end of the year is the amount by which

40% of the lesser of

(i) its taxable income, and

(ii) its taxed capital gains

for that year and any previous year throughout which it was a mutual fund corporation (see paragraph 6.033)

exceeds

its capital gains refunds for those years.

131(6) (d)

6.049 A mutual fund corporation which does not qualify as an investment company is not entitled to the 25 percentage point reduction from the normal corporate rate. Furthermore, it is subject to the Part IV tax on taxable dividends received. Payment of an ordinary dividend may result in a refund of refundable dividend tax. Payment of a capital gains dividend or redemption of shares may generate a capital gains tax refund. See paragraph 6.045 and 6.047.

Closed-end Mutual Funds

6.050 While closed-end mutual fund corporations are not recognized as mutual fund corporations under the Income Tax Act, those that qualify as investment corporations will be taxed as such. Those that do not so qualify will be taxed as ordinary corporations.

(C) Mutual Fund Trust

6.051 A mutual fund trust is essentially an open-end unit trust and is defined as a trust that at a particular time

(a) was a unit trust resident in Canada,

(b) had as its only undertaking the investing of funds of the trust, and

(c) complied with prescribed conditions relating to the number of its unit holders, dispersal of ownership of its units and public trading of its units.

132(6)

6.052 Units are merely the trust equivalent to shares without the rights normally attached to shares.

6.053 A trust is a unit trust if it was an inter vivos trust and the interest of each beneficiary was described by reference to units of the trust and

the issued units of the trust included

(i) units having conditions attached thereto that required the trust to accept at the demand of the holder (at prices described in such conditions) the surrender of the units or

(ii) units with conditions relating to the redemption of units by the trust

and the fair market value of the units mentioned in (i) or (ii) that is, the redeemable units, must equal at least 95% of all the issued units,

or

the trust has met certain investment provisions similar to those outlined for investment companies.

108(2)

6.054 A mutual fund trust that operates as a unit trust but does not meet the qualifications above is subject to the general rules for taxation of trusts.

6.055 If the trust does not disburse all of its income for the year to its unit holders, it becomes taxable on the portion retained. A minimum rate of 39% will apply, and, on capital gains there will be no higher rate. If, however, taxable income, computed as though there were no capital gains or losses, should be in excess of the amount which would result in tax payable equal to 39% if it were taxable income of an individual, then the individual income tax rates will apply instead of the 39% rate on that taxable income.

122(3)

6.056 The mutual fund trust because it is not incorporated may, as before 1972, allocate on a unit basis and pass its income to its unit holders without altering the identity of the income. Similarly, unallocated income continues to be taxable in the hands of the mutual fund trust without loss of identity. If the trust disburses all of its income of a year to its unit holders, the trust has no tax to pay. The unit holders will report their portion of the income, pay tax and claim credits as though the trust did not intervene.

6.057 There is provision in the Act for recovery by the mutual fund trust of federal taxes paid on capital gains. Since a mutual fund trust redeems its units at the request of the unit holders in much the same manner as a mutual fund corporation redeems its shares, the opportunity to recover capital gains tax through these unit redemptions is available to the trust under a similar redemption formula. The formula used by a mutual fund corporation for the redemption of its shares is applicable to a mutual fund trust.

CO-OPERATIVES AND PATRONAGE DIVIDENDS

Changes in Taxation

6.058 There are three major changes to the provisions affecting co-operatives which are as follows:

(1) Removal of the exempt period for the first three years of a co-operative effective January 1, 1972. There are no transitional provisions affecting this change, so should any co-operative be in the midst of an exempt period on December 31, 1971, such exempt status would be lost effective January 1, 1972.

135

(2) The former restriction on the amount of deductible patronage dividends which was based on capital employed has been withdrawn. In effect, patronage dividends paid to customers are deductible in computing the income of the co-operative to the extent that they represent income from business.

(3) A withholding tax of 15% applies after 1971 on annual patronage dividends in excess of $100 paid to a resident of Canada. Patronage dividends paid to a non-resident are subject to non-resident withholding tax. The 15% tax withheld from a resident applies against his tax liability for the year, and would be refundable to the extent that it exceeds that liability.

135(3)

Calculation of Tax

6.059 Special transitional rules apply in calculating tax payable by a co-operative whose 1972 taxation year straddles December 31, 1971. In effect, the tax is first calculated on the income of the whole taxation year as though Part I of the old Act applied and is calculated again under the new Act, and then the two tax amounts are pro-rated on the appropriate daily basis.

ITAR 57.1

A co-operative that can qualify as a "Canadian-controlled private corporation" is entitled to the small business deduction, and is liable to Part V tax on ineligible investments. Co-operatives are not subject to Part IV tax on dividends received.

CREDIT UNIONS AND SAVINGS AND CREDIT UNIONS

6.060 Credit unions are subject to income tax after January 1, 1972. The new Act describes the term "credit union" as a corporation, association or federation incorporated or organized as a credit union or co-operative credit society, the revenue of which is derived primarily from specific sources and whose members, if not individuals, meet certain tests.

137(6) (b)

Transitional Provisions

Investments and Accounts Receivable

6.061 For the purpose of computing income for 1972 and subsequent taxation years, investments in bonds, debentures, hypothecs, or agreements of sale owned at the beginning of the 1972 taxation year shall be valued at cost, plus or minus an appropriate amount in respect of amortized discounts or premiums where the cost was less, or more, than the principal amount. For illustration, the value at December 31, 1971, of a ten year bond purchased on January 1, 1967, for $940 would be determined as follows:

ITAR 58 (1)

Formula

$$\frac{\text{Period from date of purchase to December 31, 1971}}{\text{Total period from date of purchase to date of maturity}} \times \text{Amount of discount or premium}$$

$$\frac{60 \text{ months}}{120 \text{ months}} \times \$60 \text{ discount} = \$30$$

The value at December 31, 1971, would be $970.

Accounts receivable, or debts owing to the credit union, acquired before the beginning of the 1972 taxation year shall be valued at any time at the amount outstanding at that time. Debts which were established as bad debts before the 1972 taxation year are not so valued.

Depreciable Property

6.062 Depreciable property acquired before 1972 shall be deemed to have a capital cost computed in a special way for each of three groups of assets, namely

(1) buildings or automotive equipment
(2) leasehold interests
(3) any other capital property, which is depreciable.

The following examples illustrate the method of computing the deemed capital cost of each of the three groups of assets, assuming a December 31st year end.

(1) Buildings or automotive equipment—

The actual historical cost of each building is determined and then this cost is reduced by a straight-line depreciation allowance of 2½% times the number of full taxation years from date of acquisition to the end of 1971 taxation year.

Historical cost of building acquired in 1963	$340,000
Deemed depreciation allowances (8 years × 2½% = 20%)	68,000
Deemed capital cost—January 1, 1972	$272,000

Any addition to a building costing in excess of $10,000 is treated as a separate building. Additions of less than $10,000 are added to the historical cost of the original building.

The treatment of automotive equipment is similar to that of buildings, but the straight-line rate is 15%.

(2) Leasehold interests—

The costs are determined according to the amortized values on the first day of the 1972 taxation year. The formula, which is applied to each leasehold property held, is—

$$\frac{\text{Number of months remaining in lease in the period commencing with the first day of 1972 taxation year}}{\text{Total number of months in lease}} \times \text{Total cost of leasehold interest}$$

(3) Any other capital property which is depreciable—

For furniture and equipment, and all other depreciable property on hand at the start of the 1972 taxation year (other than buildings, automotive equipment and leasehold interests referred to in (1) and (2) above), the method is to determine the historical cost of each such asset acquired after 1961. The assets will be gathered by years and by prescribed classes at historical cost. One-half the normal rate of capital cost allowance times the number of full taxation years from date of acquisition to the end of the 1971 taxation year is deducted. To illustrate, assume that a credit union with a December 31 year end acquired furniture and fixtures in each of its last four taxation years before 1972. The computation of the deemed capital cost of Class 8 would be as shown in the Example at the foot of the page.

Reserves

6.063 To establish the tax position of the actual reserves on hand at the end of the 1971 taxation year of a credit union, the first step is to determine the amount of the "1971 reserve". The "1971 reserve" (as defined in the transitional provisions) is the aggregate of

(i) cash at the commencement of the 1972 taxation year

(ii) investments and accounts receivable valued as in paragraph 6.061 above

(iii) depreciable property valued as in paragraph 6.062 above, and

(iv) other capital property owned at the commencement of the 1972 taxation year, at cost

less the aggregate of

(v) all debts owing by the credit union at the commencement of the 1972 taxation year other than members' shares, and

(vi) members' shares at that time.

ITAR 58(5) (c)

It will be evident from the above that the "1971 reserve" is the retained earnings and reserves of a credit union at the end of its 1971 taxation year calculated on a tax basis.

The next step is to allocate the "1971 reserve", to the extent that it is available, to items (1), (2), and (3) below, and in that order.

(1) the maximum prescribed reserve (to be prescribed by regulation) at the end of the 1971 taxation year for bonds, debentures, agreements of sale, mortgages or hypothecs,

(2) the maximum prescribed reserve at the end of the 1971 taxation year for other debts owing to the credit union,

(3) the maximum cumulative reserve (5% of the amounts owing to members on account of deposits, loans and shares at the end of the 1971 taxation year).

ITAR 58(2) (c)

Any excess of the "1971 reserve" over the total of the amounts in (1), (2), and (3) above is regarded as tax-free surplus arising prior to 1972.

Example	1968	1969	1970	1971	TOTAL
Historical cost	$1,000	$1,200	$1,600	$1,000	$4,800
Deemed allowances at 10% (½ prescribed rate)					
3 years at 10%	(300)				(300)
2 years at 10%		(240)			(240)
1 year at 10%			(160)		(160)
Deemed capital cost—January 1, 1972	$ 700	$ 960	$1,440	$1,000	$4,100

If the "1971 reserve" is negative, the shortage is deemed to be a 1971 non-capital loss of the credit union available for carry-forward.
ITAR 58(4.1)

The amounts allocated to (1) and (2) above are deemed to have been allowed as deductions in computing the income for the 1971 taxation year; consequently they are to be included in income for the 1972 taxation year—see paragraph 6.064.
ITAR 58(2) (c)

The amount allocated to the maximum cumulative reserve in (3) above is deducted from the amount of the maximum cumulative reserve in subsequent taxation years—see paragraphs 6.069 to 6.074.

Example of "1971 Reserve" Allocations

	Credit Union A	Credit Union B	Credit Union C
"1971 Reserve" determined	($2,000)	$20,000	$40,000
Allocated			
Reserve for bonds etc. (1)	—	2,000	2,000
Reserve for debts (2)	—	10,000	10,000
Maximum cumulative reserve (3)	—	8,000	12,000
Tax-free surplus	—	—	16,000
	($2,000)*	$20,000	$40,000

*In credit union "A" a 1971 non-capital loss of $2,000 exists.

Deductions in Computing Income

Reserves for Investments and Accounts Receivable
6.064 In lieu of an ordinary reserve for doubtful accounts, a credit union can deduct reserves, not exceeding an amount to be prescribed by regulation, for its investments such as bonds, debentures, agreements of sale, hypothecs, or mortgages, and for other debts owing to the credit union. Such reserves claimed in a taxation year are added to the income of the following taxation year with a new reserve being established at the end of each year.
137(1)

Interest Paid on Shares
6.065 Any annual or periodic amount paid or payable by a credit union to a member in respect of his share (except on account of capital) shall be deemed to have been paid as interest. Likewise, the member is deemed to have received interest. In computing the income for a taxation year, the only interest that is deductible is that amount payable in respect of that year (whether or not paid in that year).
137(4.1)

Allocations in Proportion to Borrowing (Interest Rebates)
6.066 Payments made to members pursuant to allocations in proportion to borrowings (in respect of interest which became payable by the member after the commencement of the 1972 taxation year) are deductible by the credit union without limitation. To be deductible in a taxation year, the payments must be made within the taxation year or within twelve months thereafter.
137(2), ITAR 58(4)

Calculation of Tax

Taxation Year 1972 not Coinciding with Calendar Year
6.067 Where the 1972 taxation year straddles December 31, 1971, the tax payable under the new Act for the whole year is pro-rated according to the number of days in 1971 and in 1972, and only the tax so pro-rated to 1972 is payable in respect of the 1972 taxation year.
ITAR 58(3)

6.068 Credit unions are not subject to Part IV tax on dividends received.

Additional Deduction for Credit Unions
6.069 The effect of the additional deduction from tax for credit unions is to permit the 25% corporate rate to apply on income which may be needed to build up a reserve (because of the various statutory reserves requirements) equal to 5% of all amounts owing to members, and of the amount of any share in the credit union held by a member. This 5% reserve is called the "maximum cumulative reserve".
137(3), 137(6) (c)

6.070 The amount of the additional deduction in a taxation year, which is additional to the small business deduction provided for in Section 125 (see paragraphs 2.020 to 2.036) is calculated as follows:

25% in 1972 (reducing by one percentage point a year to 21% in 1976 and subsequent years) of the lesser of

(a) the excess of the taxable income for the year over the amount thereof which qualifies for the small business deduction under Section 125, and

(b) the excess of $^{4}/_{3}$rds of the maximum cumulative reserve at the end of the year (see below) over the aggregate of the preferred-rate amount at the end of the preceding year (see paragraphs 2.049 and 2.050) and the amount subject to the small business deduction in the year under Section 125 (this aggregate is basically the

amount on which the small business deduction has already been claimed).

6.071 Where any of the taxation years 1973 to 1976 inclusive straddle December 31, transitional provisions similar to those discussed in paragraph 2.042 apply to appropriately adjust the above-mentioned rates (25% to 21%) of the additional deduction.
137(3.1)

Maximum Cumulative Reserve

6.072 The deduction available to build up the 5% reserve (5% of all amounts owing to members on account of deposits, loans and shares) applies only to increases in these reserves after 1971. Consequently, for the purpose of computing the deduction, transitional provisions reduce the maximum cumulative reserve for any year by the amount of the maximum cumulative reserve at the end of its 1971 taxation year to the extent that the credit union had sufficient retained earnings at that time to cover the reserve.
ITAR 58(3.2), 58(5) (c)

6.073 The maximum cumulative reserve at the end of any year is 5% of all amounts owing to members, in the form of deposits, loans, or shares at the end of the particular taxation year less the amount allocated to the maximum cumulative reserve in item (3) in paragraph 6.064.

6.074 A small credit union, whose taxable income does not exceed $50,000 a year ordinarily need not be concerned with the calculation of the additional deduction for a number of years since almost all its income will be taxable at the 25% rate through the small business deduction under Section 125. If a credit union acquires ineligible investments, Part V tax on ineligible investments may apply, see paragraphs 2.044 to 2.054.

6.075 An example of the calculation of the additional deduction for a large credit union appears below. This example may be regarded as extreme since the tax payable by the credit union at the full corporate rate (50% on $220,000) could have been avoided by making additional allocations in proportion to borrowing, or by paying additional interest on loans from members.

Example

Balance Sheet at December 31, 1972

Assume:

Assest

Investments and Accounts		Members Deposits	$2,900,000
Receivable	$5,100,000	Bank Loan	1,500,000
Less Reserve	100,000	Members' Share Capital	100,000
		Retained Earnings	500,000
	$5,000,000		$5,000,000

Gross income for year	$ 615,000 (before special deductions)
Increase in 1972 in reserve for investments and accounts receivable	50,000
Allocations in proportion to borrowing	265,000

Calculation of Income

Income (after deduction of interest paid to members)		$ 615,000
Deduct		
Increase in reserve for investments and accounts receivable	$ 50,000	
Allocations in proportion to borrowing	265,000	315,000
Taxable income		$ 300,000

Calculation of Tax

Part I tax at 50%		$150,000
Small business deduction, Section 125, 25% of least of:		
(a) 300,000 Business income		
(b) 300,000 Taxable income		
(c) 50,000 Business Limit		12,500
(d) 400,000 Total Business Limit		
		137,500
Additional Deduction		
25% of lesser of (1) or (2)		
(1) Taxable Income	$300,000	
Less Least of (a) to (d) above	50,000	
	$250,000	

Example Cont'd.

(2) Maximum cumulative reserve—

5% of $3,000,000 at December 31, 1972	150,000	
Maximum cumulative reserve, December 31, 1971 (say)	90,000	
Maximum cumulative reserve, December 31, 1972	$ 60,000	
4/3 of $60,000	80,000	
Less preferred-rate amount (nil) plus (c) above	50,000	
	$ 30,000	
25% of $30,000		7,500
Total tax payable		130,000
Less provincial tax abatement, 10% of $300,000		30,000
Federal tax		$100,000

NOTES:

1. The "build up" of the 5% reserve ($60,000) is provided out of income taxed at the 25% rate ($80,000 less tax of $20,000).
2. The cumulative deduction account under Section 125 at the end of 1972 is $300,000. This account is not affected by the additional deduction.

Transactions With Members

6.076 A credit union has three ways of allocating funds or disbursing profits to members.

1. Regular interest on deposits.
2. Regular interest or other periodic amounts payable on shares, including dividends.
3. "Allocations in proportion to borrowing" or interest rebated.

Items 1 and 2 are an allowable cost to the credit union if they otherwise qualify, and are taxable in the hands of the receiving member.

6.077 "Allocations in proportion to borrowing" (interest rebates), are an allowable cost to the credit union. They are taxable to the receiving member only if the borrowed money was used for the purpose of earning income other than exempt income. For example, if the member could claim the interest paid as a deduction from income from property or a business, then he must reduce the interest expense claimed, or alternatively report the rebated interest as income. A member using a loan to buy a personal car, and not able to claim the interest as expense to earn income, is not required to report the rebated interest.

ELECTRIC GAS OR STEAM UTILITY CORPORATIONS

6.078 For a corporation qualifying as an electric, gas or steam utility only the rates of corporate tax have changed in the new Act. Revised rates by calendar years are as follows:

	1972	1973	1974	1975	1976 and subsequent
Class A income	48%	48%	48%	47%	46%
Class B income	50%	49%	48%	47%	46%

Where taxation years do not coincide with calendar years, prorations will be required in accordance with the transitional rules.
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6.079 The special return of information, Form T2025, remains unchanged. The form T2025 will be required for the allocation of Class A & Class B incomes even after 1973, because of the transfer of a portion of the federal income tax to the provinces under the Public Utilities Income Tax Transfer Act.

6.080 To illustrate the taxing of a utility under the new rates, assume it is a "public corporation" with the following operating results for the year ended December 31, 1972.

	Sales to public Class A	Other revenue Class B	Total
Gross revenue totals—per form T2025	$9,700	$300	$10,000
Ratio	97%	3%	100%
Assessed taxable income Allocated in Ratio	$ 970	$ 30	$ 1,000

Tax on Class A 48% on $970	$465.60
Class B 50% on $ 30	15.00
	480.60
Less: Provincial abatement	100.00
Federal Tax	$380.60

6.081 In the event that the utility is a Canadian controlled private corporation, it would be entitled to the benefits of the small business deduction, and would also be subject to Part IV tax (tax on dividends received) and Part V tax (tax on ineligible investments).

6.082 Many items in Class B "other Gross Revenue" shown in Form T2025, will qualify as active business revenue of a utility and are thus eligible for the small business deduction. Revenue from service connections, transportation, sale of by-products, sale or rental of appliances, sale of water, and interest charged to construction are examples of active business revenue in Class B income.

6.083 A dividend paid by a utility corporation to its shareholders receives the same treatment as a dividend paid from any other corporation to its shareholders. This means that a shareholder of a Canadian utility corporation who is an individual is required to gross up a taxable dividend by ⅓ and is entitled to the usual tax credit.

INCORPORATED PROFESSIONALS

6.084 Under the old Act, taxpayers in the professions (doctors, dentists, lawyers, public accountants, engineers, architects, etc.) have been permitted to declare their income on a "cash basis". This meant that amounts were included in income only when received and were deducted only when cash was disbursed, except those capital costs which had to be amortized.

6.085 For all fiscal years ending after December 31, 1971, taxpayers who are in the professions will be required to declare their professional income on the "receivable" method. This means that they will record as income all fees billed in respect of property sold or services rendered in the course of business, and will deduct expenses when they are incurred, again excepting capital costs which will continue to be allowed as a deduction as prescribed by regulation.
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6.086 The amounts will be deemed to have become receivable in respect of services rendered in the course of business on the day that is the earliest of

(i) the day upon which the account in respect of the services was rendered,

(ii) the day upon which the account in respect of those services would have been rendered had there been no undue delay in rendering the account in respect of the services, and

(iii) the day upon which the taxpayer was paid for the services.

6.087 Amounts received by a taxpayer in the year in the course of a business on account of services not rendered or goods not delivered before the end of the year, or amounts received that for any other reason may be regarded as not having been earned in the year or a previous year, are to be included in income. No reserve is allowed in respect of such income.
12(1) (a), 34

6.088 The new Act provides that work-in-progress need not be taken into income if the taxpayer so elects. The election will be in force up to the time when the taxpayer, with the approval of the Minister, revokes the said election.

Transitional Provisions

6.089 These provisions require a taxpayer who is in the professions to bring his 1971 Receivables and 1971 Payables existing at the end of the 1971 taxation year into the calculation of his income on the following basis:
ITAR 23

(a) All amounts payable existing at the end of the 1971 fiscal period pertaining to the business may be deducted in computing the taxpayer's income for the 1972 taxation year to the extent that they would have been deductible in computing its income for the 1971 fiscal period had they been paid in that period.

(b) All amounts which became receivable by the taxpayer in taxation years ending before 1972 and which have not been taken into income will have to be determined to establish the 1971 receivables (bad debts excluded). This amount will be taken into the 1972 income.

(c) The taxpayer may then deduct from his 1972 income an amount up to but not exceeding the lesser of

(i) 1972 net accounts receivable (net of bad debts and reserve for doubtful accounts), and

(ii) that proportion of his 1971 receivables which remains after reducing them by $^1/_{10}$.

(d) For 1973 and subsequent taxation years, the corporation will include in income the reserve claimed for the previous year, and deduct from income any amount up to but not exceeding the lesser of

(i) the reserve claimed for the previous year,

(ii) the balance of the accounts receivable at the end of the taxation year,

(iii) the balance of the 1971 receivables reduced by $^2/_{10}$ in 1973 and by a further $^1/_{10}$ in each succeeding year.

INCORPORATED PROFESSIONALS

Transitional Provisions—

Fiscal Year-end January 31	1972	1973	1974	1975
Income for year (receivable method)	$35,000	$70,000	$25,000	$55,000
Add: Prior year deduction	8,000[1]	7,200	6,400	3,800
Add: Bad debts of prior years recovered	900	—	—	—
	$43,900	$77,200	$31,400	$58,800
Less: 1971 payables	5,000	—	—	—
	$38,900	$77,200	$31,400	$58,800

[1] 1971 receivables

Deduct the least of [2]				
(i) Prior year deduction	8,000	7,200	6,400	3,800[2]
(ii) Current year receivables (less reserve for doubtful debts)	8,000	12,000	3,800[2]	10,000
(iii) 1971 receivables	8,000	8,000	8,000	8,000
Less: $^1/_{10}$ for each year thereafter	800	1,600	2,400	3,200
	7,200[2]	6,400[2]	5,600	4,800
Income from profession—	$31,700	$70,800	$27,600	$55,000

Chapter 7

INTERNATIONAL INCOME

GENERAL INTRODUCTION

7.001 The new Act reflects some changes in the system of taxing international income, but the fundamentals of the system remain the same. Residents of Canada continue to be taxed on their world income from all sources with appropriate relief being given for taxes paid on this income in foreign jurisdictions. Non-residents will continue to be subject to withholding tax on Canadian-source investment and similar income, and to normal corporate and personal rates of tax on Canadian-source business income.

7.002 However, the inclusion of capital gains in income will render Canadian residents liable for Canadian tax on foreign-source capital gains. In addition, the income of residents of Canada will include a proportionate share of certain income from foreign corporations and trusts that are regarded as "foreign affiliates" of the Canadian taxpayer.

7.003 The present exemption of foreign business corporations will be phased out over a period of five years. "Thin capitalization rules" are also to be found in the new Act under which interest paid to certain non-resident shareholders or creditors may not be deductible in computing a corporation's taxable income if the total shareholder's equity represents only a nominal proportion of the total capitalization. Finally, certain capital gains of non-residents will be subject to Canadian tax.

7.004 Many of the changes contained in the new Act will not take effect until 1976; this will allow a reasonable period of time to negotiate new tax treaties with other countries and to renegotiate existing treaties, The rules concerning the taxation of income from "foreign affiliates" may come into force in the 1973 taxation year of a Canadian taxpayer.

7.005 A more detailed consideration of the rules concerning the taxation of International Income will be effected in two distinct parts:

Foreign Income of Canadian Corporations

This, in turn, will be discussed under the following headings:

—Foreign income of Canadian corporations (other than from foreign affiliates).
—Foreign business corporations.
—Foreign affiliates.

Canadian Tax Treatment of Non-Resident Corporations

The discussion of this part will include the following:

—The rules of "thin capitalization".
—The taxation of capital gains of non-residents.
—The non-resident-owned investment corporations.
—Non-resident withholding tax.
—Additional tax on non-Canadian corporations carrying on business in Canada.

FOREIGN INCOME OF CANADIAN CORPORATIONS

Foreign Income of Canadian Corporations (other than income from foreign affiliates)

7.006 The foreign income of a Canadian corporation (other than from a foreign affiliate) consists mainly of foreign portfolio investment income and foreign branch income, or, in broader terms, non-business income and business income.

7.007 Under the provisions of the new Act, foreign tax credits are available to corporate taxpayers resident in Canada in respect of taxes paid in the foreign jurisdictions on their foreign income. With respect to business income, a provision has also been introduced permitting foreign tax to be carried forward, from the 1972 and subsequent taxation years, as a credit against tax payable in the five following years.
126, ITAR 55

7.008 The new Act also continues the rule found in the old Act providing for the deeming, under prescribed conditions, of certain other foreign taxes to be income or profits taxes and, where a taxpayer's foreign income is from sources in more than one country other than Canada, the new Act still provides for separate deductions in respect of each of the foreign jurisdictions.
126(5), 126(6)

7.009 Concerning income from foreign affiliates, special credits in the form of deductions from net income are available in lieu of the foreign tax credits mentioned above. These special rules will be discussed further in paragraph 7.035.

Non-Business-Income Tax Credit

7.010 A corporation resident in Canada at any time in a taxation year may claim the "non-business-income tax" paid to a foreign jurisdiction providing that it does not exceed an amount determined by taking the proportion of the tax otherwise payable under Part I of the Act, that the corporation's non-business income in that foreign country bears to its total income. Special rules apply to foreign affiliates for purposes of the above computation: the income from shares of a foreign affiliate is not included in the foreign non-business income of the corporation and its total income is reduced by a deduction in respect of dividends received from foreign affiliates. For the purpose of the calculation of the non-business-income tax credit, the total income of the corporation is also to be reduced by the claims for net capital losses of other taxation years and the amount of taxable dividends received which are deductible in computing taxable income.
126(1)

7.011 In computing the foreign tax credit, "non-business-income tax" is defined to include any income or profits taxes paid not only to the central government of a foreign country but also to states, provinces or other political subdivisions of foreign countries, providing that such taxes do not qualify as "business-income taxes" as defined below in paragraph 7.014.
126(7) (c)

7.012 In making the non-business-income tax credit calculation, the "tax for the year otherwise payable under this Part" is the tax computed on the taxable income of the corporation less the provincial abatement but before any other deductions which may be available.

Business-Income Tax Credit

7.013 The second type of foreign tax credit which may be claimed is mainly for the benefit of those corporations resident in Canada at any time in a taxation year which operate branches in foreign countries. The deduction will be equal to such part of the business income taxes paid to a foreign jurisdiction for the year plus any "foreign tax carryover" from other years in respect of the same foreign country as the corporation might wish to claim, providing that it does not exceed that proportion of the tax otherwise payable under Part I of the Act that the foreign business income of the corporation bears to its total income for the year. The same deductions from income in respect of foreign affiliates, net capital losses and taxable dividends, as were outlined above under the non-business-income tax credit, are to be made.
126(2)

7.014 In computing the credit, "business-income tax" is assigned virtually the same definition as non-business-income tax, except that it includes only the income or profits taxes paid that may reasonably be regarded as taxes in respect of the income of the corporation from a business carried on by it in the foreign country. In the event that such taxes are deductible from income in the foreign jurisdiction, they will then be allowed as a deductible expense for the purpose of computing the income of the corporation in Canada, instead of being included in the foreign tax credit calculation. On the other hand, "tax for the year otherwise payable under this Part" means the tax calculated on the taxable income of the corporation before any deduction.
126(7) (a), 20(12)

7.015 Any excess of business-income taxes paid to a foreign jurisdiction for a particular taxation year over the amount allowable as a credit against Canadian taxes for that year may be carried forward for up to five years. However, there is no carry-back provision.

7.016 As indicated above, "foreign-tax carryovers" must be maintained for each separate foreign jurisdiction. The foreign-tax carryover for a particular taxation year will be determined by establishing *the lesser of* the two following amounts:

(a) The excess of the business-income taxes paid plus the foreign-tax carryover of the corporation for the immediately preceding taxation year over the proportion of the total tax of the corporation that its foreign-business income bears to the corporation's total income for the preceding year; and,

(b) The sum of the following: the excess of business-income taxes paid for a year over the proportion of the total tax of the corporation that its foreign-business income bears to the corporation's total income calculated for each of the five preceding years.

An example of the foreign-tax carryover is as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Carryover:	nil	$1,500	$1,500	$1,500	$ 900	$ 900	$250[3]
Tax paid:	$2,500	2,200	1,800	1,000	1,200	1,300	
	2,500	3,700	3,300	2,500	2,100	2,200	
Tax "used":	1,000	2,200	1,800	1,600[2]	1,200	1,050	
Excess of carryover plus tax paid over tax "used":	1,500	1,500	1,500	900	900	1,150	
Excess of tax paid over tax "used":	1,500[1]	nil	nil	nil	nil	250	

Notes:

(1) In year 2, there was a $1,500 carryover from year 1.

(2) This amount represents $1,000 of tax paid in year 4 plus $600 taken from the carryover, leaving a balance of $900 for carryover in year 5.

(3) As the $1,500 carryover in year 1 was not completely used within five years, viz. by year 6, the balance of $900 is lost. The $250 carryover was created in year 6.

7.017 In the event of an amalgamation, provision has been made for foreign-tax carryovers of predecessor corporations to be used by the new corporate entity.
87(1), 87(2)

FOREIGN BUSINESS CORPORATIONS

7.018 The combined effect of the new Act and the Income Tax Application Rules, 1971, is to phase out foreign business corporations from 1972 to 1975. A corporation qualifying as a foreign business corporation under the old Act for its last taxation year commencing before 1972 will be allowed a deduction in computing its taxable income based on the following percentage of its foreign business income for its four taxation years commencing after 1971:

—for its first such taxation year:	80%
—for its second such taxation year:	60%
—for its third such taxation year:	40%
—for its fourth such taxation year:	20%

Should the 1972 taxation year of the corporation commence in 1971, the 1972 taxable income will be fully exempt and the decreasing exemption will start in the 1973 taxation year.
ITAR 60

7.019 Foreign business income taxes paid by the corporation will qualify for a foreign tax credit. If the foreign business corporation was a private corporation at any time during the year (see paragraph 2.005) it may become liable for Part IV tax on taxable dividends received (see paragraph 2.062). Both the foreign tax credit and the additional Part IV tax will be reduced on a basis which corresponds to the reduction of the exemption outlined above.
ITAR 60(2) (b), 60(2) (c)

7.020 Dividends paid by foreign business corporations after 1971 to Canadian residents will be eligible for the new dividend tax credit. In addition, the existing exemption from non-resident withholding tax on certain dividends paid by a corporation that would be a foreign business corporation under the old Act will continue.
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FOREIGN AFFILIATES

7.021 The new Act contains special rules for the taxation of income from foreign affiliates. These rules will alter the treatment of dividends received by the corporation resident in Canada from the affiliate and require to be included in the income of the corporation resident in Canada a proportionate share of the "foreign accrual property income" of the foreign affiliate.

Definition of a Foreign Affiliate

7.022 A "foreign affiliate" of a taxpayer resident in Canada is a corporation not resident in Canada which meets any one of the following conditions:
95(1) (b)

(a) it is controlled directly or indirectly in any manner whatever by the taxpayer or the taxpayer and a non-arm's length group of taxpayers, OR

(b) the taxpayer or the taxpayer and a non-arm's length group of taxpayers resident in Canada own at least 25% of the "voting percentage" of the foreign corporation, OR

(c) the taxpayer or the taxpayer and a non-arm's length group of taxpayers resident in Canada own at least 50% of the "equity percentage" in the foreign corporation, OR

(d) the taxpayer or the taxpayer and a non-arm's length group of taxpayers resident in Canada own at least 10% of the "voting percentage"

and the taxpayer elects to have the foreign corporation treated as a foreign affiliate.

7.023 For the purposes of this definition, each of the terms "voting percentage" and "equity percentage" is assigned a particular meaning. The "voting percentage" is based upon the number of voting shares of the foreign corporation owned directly by the taxpayer plus those owned indirectly by him through another foreign affiliate. The "equity percentage" is determined by the number of the foreign corporation's shares of any class, irrespective of their voting rights, owned directly by the taxpayer or owned indirectly by him through another foreign affiliate. For the purpose of computing "equity percentage" there are special provisions applicable when the foreign corporation has more than one class of shares and, under certain circumstances, income bonds or debentures issued by a foreign affiliate may be deemed to be shares.
95(4)

General Rules for the Taxation of Foreign Affiliate Income

7.024 In order to comprehend the general rules for taxing foreign affiliate income, it is best to look at the foreign affiliate from the standpoint of its earnings or surpluses. The new Act recognizes two basic types of surplus: exempt surplus and taxable surplus. Dividends paid by the foreign affiliate out of either type of surplus are included in income on distribution, but the difference lies in the area of deductions allowed from these dividends when computing the income or the taxable income of the recipient shareholder.

Exempt Surplus

7.025 The exempt surplus of a foreign affiliate will include, among other things:

(a) control period earnings for the 1972 to 1975 taxation years of the foreign affiliate from an active business carried on by it anywhere, less applicable underlying foreign profits taxes;

(b) control period after-tax earnings after the 1975 taxation year of the foreign affiliate from an active business carried on by it in a foreign country with which Canada has an income tax treaty; and,

(c) the "foreign accrual property income" less foreign accrual taxes of the foreign affiliate, and generally inter-affiliate dividends (net of foreign tax), generated anywhere in taxation years commencing on or after January 1, 1973.

N.R.

7.026 The exempt surplus of a foreign affiliate will be reduced by that portion of any dividend that is deemed to be paid out of exempt surplus. Such dividends, when received, will not be taxed in the Canadian corporate shareholder's hands because they will be deducted in computing the income or the taxable income of the shareholder. The exempt surplus will also have to be reduced when the same taxpayer resident in Canada acquires additional shares in the foreign affiliate.
90(2), 113(1) (a)

Taxable Surplus

7.027 The taxable surplus will contain the after-tax control period earnings from active business generated after 1975 where either the business is carried on in a non-treaty country or the foreign affiliate is incorporated in a non-treaty country. This surplus will be reduced by dividends deemed paid out of it.
N.R.

7.028 It will be necessary to keep a record of the underlying foreign taxes related to the earnings included in the taxable surplus since dividends paid out of it will be subject to a deduction on account of applicable foreign tax. The amount of the deduction allowed will be equal to the lesser of the amount of the dividend paid and the amount of underlying foreign tax paid which is related to the dividends plus twice any withholding tax payable on such dividend.
113(1) (b)

Pre-Acquisition Surplus

7.029 The existence of a third surplus of a foreign affiliate should be noted; the "pre-acquisition surplus", which represents an amount of surplus for which no records need be kept. It is simply a notional source of dividends, being anything other than exempt or taxable surplus.
N.R.

Order of Dividend Distribution

7.030 In order to enable Canadian corporate shareholders, in most circumstances, to foresee the Canadian tax implications of receiving a dividend from a foreign affiliate, the timing or order of dividend distributions of a foreign affiliate will be prescribed by Regulations. The order will be as follows:

(a) First, out of exempt surplus at the date the dividend was paid;

(b) Second, out of taxable surplus, at the time the dividend was paid;

(c) Where in the first three months of the foreign affiliate's taxation year the dividends paid exceed the total of the foreign affiliate's exempt and taxable surpluses, then the dividends will be deemed to have been paid out of the pre-acquisition surplus of the foreign affiliate, thus necessitating an adjustment to the cost base of the shares; and,

(d) Where a dividend paid after the third month of the foreign affiliate's taxation year exceeds the total of its exempt and taxable surpluses at the date of the dividend, the dividend will be treated as:

(i) first, a distribution of the exempt surplus of the foreign affiliate as of the end of the taxation year,

(ii) second, a distribution of the foreign affiliate's taxable surplus as of the end of the taxation year, and

(iii) last, as a distribution out of the foreign affiliate's pre-acquisition surplus, again requiring an adjustment to the cost base of the shares.

N.R.

The Rules Concerning "Foreign Accrual Property Income" (FAPI)

7.031 Foreign accrual property income is defined as the excess of property income, income from businesses other than active businesses and taxable capital gains over the sum of losses from property, losses from businesses other than active businesses and allowable capital losses.
95(1) (a)

7.032 Dividends from other foreign affiliates (inter-affiliate dividends) are excluded from FAPI. In addition, FAPI does not encompass taxable capital gains or allowable capital losses resulting from the disposition of tangible property used exclusively in the foreign affiliate's active business.

7.033 Capital gains and losses which may be reasonably considered to have accrued before the foreign corporation became a foreign affiliate are not to be taken into account when determining taxable capital gains or allowable capital losses. Since under the Income Tax Application Rules, 1971, foreign corporations that are foreign affiliates on January 1, 1972, are deemed to have become foreign affiliates on that day, it follows that capital gains or losses accrued before January 1, 1972, need not be taken into account.
95(2), ITAR 35

7.034 Under the provisions of the new Act, a proportionate share of the foreign accrual property income of a foreign affiliate must be included in the income of its shareholders resident in Canada. This proportionate share of the foreign affiliate's foreign accrual property income, computed as of the end of its fiscal year, is included in the income of the shareholder resident in Canada for its taxation year in which the foreign affiliate's fiscal period ended.
91(1)

7.035 In computing its taxable income, the corporate shareholder resident in Canada is allowed deductions from the foreign affiliate's FAPI notionally included in its domestic income. The deductions are designed to offset the effect of the "foreign accrual tax applicable" which is defined as the income or profits taxes paid by the foreign affiliate to the jurisdiction in which the foreign accrual property income was earned. In fact, the deduction allowed is equal to the lesser of the amount of FAPI included in the shareholder's income and two times the foreign accrual tax applicable.
113(3)

7.036 In addition to including in their income the appropriate amount of a foreign affiliate's foreign accrual property income, corporate shareholders resident in Canada must also include in their income their proportionate share of dividends received by one foreign affiliate from another foreign affiliate, unless the dividend is excluded by regulation. An amount may, however, be deducted on account of foreign taxes in respect of the income. It should be noted that inter-affiliate dividends are taxable in the Canadian shareholder's year during which the foreign affiliate received the dividend from the other foreign affiliate.
91(1) (b), 113(3)

7.037 In order to exclude from the taxable income of a shareholder resident in Canada any foreign accrual property income and inter-affiliate dividends the amount of which might be considered insignificant, provision has been made for the shareholders not to include in income in a taxation year any such amount provided that it does not exceed $500.
91(2)

7.038 Where the inclusion in a taxpayer's income for the year of the whole amount of his proportionate share of FAPI from a foreign affiliate would result in undue hardship to him because of monetary or exchange restrictions imposed by the law of another country, a

reserve may be deducted. Such reserve as was claimed for the preceding year must be included in computing a taxpayer's income for a particular taxation year.
91(3)

7.039 Corporations resident in Canada must keep full particulars of the adjusted cost base of their shares in foreign affiliates. Special rules requiring adjustment to the cost base of the shares are applicable in the event of additional purchases or sales of foreign affiliates' shares. Foreign accrual property income and inter-affiliate dividends taxed as income in the hands of the corporate shareholder resident in Canada will have to be added to the adjusted cost base of the shares. However, dividends received out of exempt surplus of the foreign affiliate will be deducted from the adjusted cost base to the extent of the additions previously made.
92

7.040 As indicated above in paragraph 7.030 the adjusted cost base of the shares in the foreign affiliate will also be reduced by the amount of a dividend deemed to be out of pre-acquisition surplus. Under special circumstances, post 1975 dividends out of taxable surplus are treated as a return of capital and may also reduce the adjusted cost base of the shares.
90(3), 92(3), 113(2)

CANADIAN TAX TREATMENT OF NON-RESIDENTS

7.041 As indicated above in paragraph 7.005 this part will deal with the following points:

—the "thin capitalization" rules;
—capital gains of non-residents;
—non-resident-owned investment corporations;
—non-resident withholding tax; and,
—additional tax on non-Canadian corporations carrying on business in Canada.

The "Thin Capitalization" Rules

7.042 Under special circumstances, in computing the income of a corporation resident in Canada, no deduction can be made in respect of interest payable on outstanding debts to specified non-residents. These rules, known as the "thin capitalization rules", were discussed above under the heading: Determination of income. (See paragraph 1.023)
18(4)

Capital Gains of Non-Resident Corporations

7.043 Under the terms of the new Act, a non-resident corporation must include in its income earned in Canada, taxable capital gains and allowable capital losses arising out of dispositions of "taxable Canadian property". This rule is, of course, subject to the provisions of Income Tax Conventions between Canada and other countries, including the United States, the United Kingdom, West Germany, Japan, Sweden and Finland.
115, 116

7.044 For the purposes of the foregoing, "taxable Canadian property" will include:

(a) real property situated in Canada or an interest therein;

(b) other capital property used by the non-resident in carrying on a business in Canada;

(c) shares of the capital stock of a corporation resident in Canada, other than a public corporation (see paragraph 2.001 for a discussion of the various types of corporations);

(d) shares of the capital stock of a public corporation, if, at any time during such of the period of five years immediately preceding the disposition as is after 1971, at least 25% of the issued shares of any class were held by the non-resident and/or persons with whom he is not dealing at arm's length;

(e) an interest in certain partnerships;

(f) a capital interest in a trust, other than a unit trust, resident in Canada;

(g) a unit of a unit trust, other than a mutual fund trust, resident in Canada; and,

(h) a unit of a mutual fund trust under certain conditions.

7.045 Non-residents will be subject to the same general rules with respect to capital gains and losses as Canadian residents. Readers are reminded of the separate comprehensive publication "Capital Gains" where a full discussion of this topic will be found.

7.046 In connection with the disposition of "taxable Canadian property", non-residents should keep in mind the provisions of Section 116 of the new Act respecting the Certificate which may be obtained from the Minister of National Revenue with respect to a proposed disposition and the estimated amount of the proceeds.

Non-Resident-Owned Investment Corporations

7.047 Commencing with their 1972 taxation year, non-resident-owned investment corporations (N.R.O.'s)

will pay tax on their net taxable capital gains from dispositions of taxable Canadian property at the rate of 25% while the excess of their taxable income over such capital gains will continue to be taxed at the rate of 15% up to and including 1975. For 1976 and subsequent taxation years, N.R.O.'s will pay tax on all their taxable income at the rate of 25%.
133(3), ITAR 59(1)

Definition of an N.R.O.
7.048 Until 1975 the general definition of a non-resident-owned investment corporation will remain essentially the same as under the old Act except that foreign affiliates (see paragraph 7.022) of corporations resident in Canada will not qualify as non-residents for the purpose of owning the shares, the bonds and the debentures of the N.R.O. For 1976 and subsequent taxation years it will be necessary for all issued shares, debentures and bonds of the N.R.O. to be owned by non-residents instead of the present minimum requirement of 95%.
133(8), ITAR 59(2)

7.049 The requirements regarding the composition of the income of a non-resident-owned investment corporation have been changed to include income from disposition of taxable Canadian property. This is to reflect the intention of the new Act to include capital gains and losses on disposition of capital property in the computation of taxable income.

7.050 It must be noted that in order for a corporation to qualify as an N.R.O., an election must be made in a prescribed manner within 90 days after the commencement of its first taxation year commencing after 1971. Thus, if a corporation chooses to revoke its election in a particular taxation year after 1972, it cannot elect to become an N.R.O. again. New corporations formed after June 18, 1971, by way of amalgamation will qualify as N.R.O.'s only if each of their predecessor corporations so qualified. In addition, after June 18, 1971, it will be possible to incorporate a new company as an N.R.O., but such company will have to qualify from the date of incorporation.

The Computation of the Income of an N.R.O.
7.051 The income and the taxable income of a non-resident-owned investment corporation will generally be computed according to the rules applicable to Canadian corporations, except that no deductions are allowed for interest paid or payable and for depletion. However, this calculation will include the "taxable capital gains" or "allowable capital losses" only from dispositions of taxable Canadian property or property that would qualify as such if at no time in the year the corporation had been resident in Canada. It must be noted that for the purposes of computing the "income" of an N.R.O., "taxable capital gains" or "allowable capital losses" means the full amount of capital gains and losses. In addition, capital dividends (see paragraph 2.100) received by an N.R.O. shall be included in the computation of its income and its taxable income for the year. Capital gains dividends received from another non-resident-owned investment corporation are however not included in the calculation.
133(1), 133(7.1)

7.052 The new Act provides for special rules concerning the payment of capital gains dividends out of a non-resident-owned investment corporation's capital gains dividend account. The capital gains dividend account of an N.R.O. will include capital gains from dispositions of Canadian property and shares of another N.R.O., and the amount of capital gains dividends received. It will be reduced by the amount of capital losses from dispositions of Canadian property and 25% of the amount by which capital gains from taxable Canadian property exceeds capital losses therefrom. The account will further be reduced by the amount of capital gains dividends that have become payable out of it.
133(7.1)

7.053 It should be noted that capital gains dividends are not subject to Canadian withholding tax when paid or credited to non-residents.
212(2)

Allowable Refunds
7.054 Commencing with the 1972 taxation year, non-resident-owned investment corporations will be able to obtain refunds of most of the taxes paid under Part I of the new Act, if certain conditions are met. In fact, all taxes paid on the taxable income, except taxes paid on capital gains from dispositions of taxable Canadian property, will be eligible for refund when dividends are paid by the N.R.O. and the relevant withholding taxes are remitted. However, taxes paid equal to one-third of interest paid on the N.R.O.'s bonds, debentures etc. (which is not deductible for tax purposes) will not be refunded; it will be noted that such interest is not subject to withholding tax.

7.055 The "allowable refund" will be an amount equal to that proportion of the taxable dividends paid in a year that the "allowable refundable tax on hand" is of the greater of the amount of the dividends so paid and the "cumulative taxable income" of the N.R.O.
133(8) (a)

7.056 Broadly defined the "allowable refundable tax on hand" at a particular time means the excess of all taxes paid by the N.R.O. under Part I of the Act for taxation years commencing after 1971, over the sum of:

(a) 25% of the full amount of its net taxable capital gains from dispositions of taxable Canadian property after 1971;

(b) ⅓ of all interest paid after the commencement of its 1972 taxation year ($^{15}/_{85}$ for 1972 to 1975 taxation years); and,

(c) the allowable refunds previously received since its first taxation year commencing after 1971.

In the case of an amalgamation creating a new non-resident-owned corporation, the allowable refundable tax on hand of the predecessor corporations immediately before the amalgamation should be added to the new corporation's allowable refundable tax on hand.

7.057 Also defined in general terms, the "cumulative taxable income" for the same period represents the excess of all taxable incomes of the N.R.O. for taxation years commencing after 1971, over the sum of:

(a) the full amount of its net taxable capital gains from dispositions of taxable Canadian property after 1971;

(b) $^{4}/_{3}$ of the interest paid after the commencement of its 1972 taxation year ($^{100}/_{85}$ for 1972 to 1975 taxation years); and,

(c) the amount of all taxable dividends previously paid since the commencement of its first taxation year commencing after 1971.

133(9) (b)

7.058 Readers should keep in mind the fact that Subsection 133(9) of the new Act contains special rules for the determination of the capital gains referred to above in the definitions of "allowable refundable tax on hand" and "cumulative taxable income". In addition, there are particular provisions applicable to the calculation of allowable refunds and to the payment of dividends where the 1972 taxation year of an N.R.O. straddles December 31, 1971.

133(9)

Non-Resident Withholding Tax

7.059 The various types of Canadian investment and similar income of non-residents will generally be subject to a withholding tax of 25% commencing in 1976, unless such non-residents are domiciled in countries which have signed bilateral income tax treaties with Canada. As under the old Act the rate will be 5 percentage points less where the payer is a corporation with a degree of Canadian ownership. For taxation years in the period between 1972 and 1975 inclusive, the general withholding tax rate will remain at 15%.

212 to 218, 212(3)

Interest and Discount

7.060 Subject to the increased rate after 1976, the withholding tax provisions on interest paid to non-residents will remain generally unchanged. Interest that is exempt from withholding tax under the old Act will continue to be exempt under the new Act except for the following modifications:

212(1) (b)

(a) the exemption for interest on government and government-guaranteed bonds and obligations will be continued only for those issued before 1976;

(b) interest payable in foreign currency on obligations entered into in the course of carrying on business in another country will only be exempt where the payment is made at arm's length and such interest is deductible in computing the income of the taxpayer from carrying on business in such country for Canadian tax purposes;

(c) interest payable on obligations held by a creditor to whom a certificate of exemption has been issued will remain exempt from withholding tax. However, additional requirements have been included for a non-resident person to obtain a certificate of exemption. The applicant must continue to be a resident of a country which imposes an income tax from which he is exempt; in addition, with the exception of a trust or corporation established for an employee's superannuation or pension plan or fund, non-resident applicants for exemption certificates will be required to show that if they had been resident in Canada they would have been exempt from Canadian income tax.

7.061 Under the provisions of the new Act, when a short-term obligation or security is transferred by a non-resident to a person resident in Canada, the interest accrued up to the date of such transfer or assignment will be subject to withholding tax and the resident transferee will be required to withhold such tax. This rule is applicable to obligations (other than income bonds or in-

come debentures) which are issued after June 18, 1971, and where the interest is not in respect of an "excluded obligation" (paragraph 7.065), the issuer is not obliged to pay more than 25% of the principal within 5 years, and the obligation is not in the nature of a public issue security.

7.062 Where the transferee is a non-resident-owned investment corporation, it is also required to withhold the applicable tax under these circumstances.

7.063 Where the transferee is a non-resident person carrying on business in Canada who may deduct, in computing his income, an amount in respect of interest on the obligation, he is deemed to be a resident of Canada and must withhold the appropriate tax on the payment to the non-resident.
214(9)

7.064 On the other hand, where a person resident in Canada issues or sells at a discount to a non-resident person, a bond, debenture, bill, note, mortgage, hypothec or similar obligation, other than the obligations excluded (see paragraph 7.065 below) issued after June 18, 1971, he is liable to withhold at the time of issue or sale the tax on an amount equal to $^{100}/_{85}$ ($^{4}/_{3}$ commencing 1976, when the withholding tax rate will be 25%) of the discount as in the following example:

Face Value of bond, excluding interest or premium payable on redemption before maturity	$20,000
Sold at	$18,300
Discount	$ 1,700
$^{100}/_{85}$ of discount of $1,700	$ 2,000
Withholding tax—15% of $2,000	$ 300
Remit to non-resident taxpayer	$ 1,700

If before maturity of the obligation, the non-resident person sells the obligation to a person resident in Canada, the amount of the tax that the non-resident person is liable to pay shall be deemed to be that proportion of the tax that the number of days he held the obligation is of the number of days from the date of sale or issue to him until its maturity. The non-resident taxpayer must claim the refund in writing within 2 years from the end of the calendar year in which the amount was paid.
214(7), 214(8), 214(10)

7.065 The withholding tax is not levied on the discount if it is for:

(a) certain obligations where the interest is already exempt;

(b) obligations where the issuer is not obliged to pay more than 25% of the principal within 5 years;

(c) obligations in the nature of a public issue security; and,

(d) obligations issued for not less than 97% of principal amount, and maximum annual yield (including interest) is not greater than $^{4}/_{3}$ of annual interest.

An example of (d) above is as follows:

Notes, for $100—at 6% a year for 2 years issued at		$98
Discount yielding additional 1% a year=$1		
$^{4}/_{3}$ of $6 interest=		$ 8
Total yearly yield: interest:	$6	
discount:	$1	
		$ 7

No withholding tax needs to be paid on the discount.
212(1) (b)

7.066 Where a non-resident person carrying on business in Canada is required to include in computing his income the price for which the obligation was issued or sold, he is deemed to be resident in Canada for the purposes of Part XIII with respect to the issue or sale of this obligation, and is required to withhold the tax, if applicable.
214(10)

7.067 Finally, a non-resident-owned investment corporation that issues or sells an obligation of this kind is liable to withhold the applicable tax.
214(11)

Trusts and Estates

7.068 As under the old Act the income of a trust or an estate resident in Canada paid or payable to a non-resident beneficiary is deductible from the income of the trust or the estate for the year and treated as income of the beneficiary and as such, is subject to withholding tax. This rule does not apply to the extent that such income of the trust (other than a mutual fund trust) is deemed to be taxable capital gains of the non-resident person or of an N.R.O. from the disposition of capital property. That portion of the taxable capital gain is not deductible in computing the income of the trust with the result that it will be taxed in the trust instead of being subject to withholding tax.
104(6), 104(10), 212(1) (c), 212(11), 104(9), 104(21)

7.069 Where interest and dividends from a non-resident-owned investment corporation are received by

a trust of which all the property is owned for the benefit of non-resident persons, taxable dividends will be subject to withholding tax as being deemed income of the non-residents from the trust. Capital gains dividends, however, are not subject to withholding tax. Interest from a non-resident-owned investment corporation is exempted from withholding tax because such interest is not deductible in computing the income of that company.
104(11), 212(9), 212(2)

Rents and Royalties
7.070 The provisions of the new Act dealing with the withholding tax on rents, royalties and similar payments to non-residents are essentially the same as under the old Act. However, any such payment made on an arm's length basis will not be subject to withholding tax if the payment is deductible by the payer in computing, for tax purposes, his income from a business carried on by him in a country other than Canada.
212(1) (d)

Dividends
7.071 Taxable dividends paid by a corporation resident in Canada, and any amount deemed to be a taxable dividend (as where a corporation increases its paid-up capital, distributes its funds or property on winding-up, discontinues or reorganizes its business and redeems, acquires or cancels any of its shares) are subject to the non-resident withholding tax.
212(2)

7.072 Capital dividends from private corporations, although non-taxable dividends, are also subject to the non-resident withholding tax.

7.073 Non-taxable dividends that are paid out of tax-paid undistributed surplus on hand and 1971 capital surplus on hand are not subject to withholding tax. Capital gains dividends paid to non-residents by a mutual fund corporation or a non-resident-owned investment corporation are also exempt from the non-resident withholding tax.

7.074 Dividends paid to non-resident persons by some foreign business corporations were exempt from the non-resident withholding tax under the old Act. The exemption from Canadian corporation tax of a foreign business corporation is being gradually phased out over a period of five years at the end of which time foreign business corporations will be taxed as regular corporations. (See paragraph 7.018) In view of this fact, it is provided that, if a corporation would have been a foreign business corporation under Section 71 of the old Act as it read in its application to the 1971 taxation year, it shall be deemed to be one in order to retain the exemption of the non-resident withholding tax on these dividends.
213(3)

7.075 The following special provisions regarding the non-resident withholding tax should be noted:

(a) The special withholding tax at the rate of 10% on payments for motion picture films, or films and video tapes used by television will continue up until December 31, 1975, when it will be raised to 25%.

212(5) (c), ITAR 10(2)

(b) Where a person resident in Canada pays an amount to a non-resident who resides in a prescribed country and with whom the person resident in Canada is dealing at arm's length and the amount is on account of interest on a bond, debenture, mortgage, etc., issued before 1976, the rate of withholding tax is 15% instead of 25%.

ITAR 10(4)

(c) Where a non-resident person elects to pay tax under Part I of the Act and files a return reporting income from rents and timber royalties, the benefits of an income-averaging-annuity contract are denied.

216(5), 216(7)

Additional Tax on Non-Canadian Corporations Carrying on Business in Canada
7.076 Under the provisions of Part XIV of the new Act, non-Canadian corporations carrying on business in Canada, whether resident or not resident, will be liable to an additional tax ordinarily known as the "Branch Tax". This tax will be based on a figure calculated in a somewhat similar manner to that required in Part IIIA of the old Act which applied only to non-resident corporations. For the 1972 to 1975 taxation years the rate of the branch tax will be 15%. Thereafter the rate will be 25% unless it is reduced under a bilateral tax treaty.

7.077 In order to comprehend the general rules for calculating the branch tax, it is best to look separately at corporations resident in Canada and at those not resident in Canada.

7.078 In the case of a non-Canadian corporation resident in Canada at any time during the year, the additional tax will be imposed *on the excess* of the corpora-

tion's total taxable income plus the preceding year's allowance for investment in property and the previous year's deduction under (d) below in respect of dividends out of Canadian source earnings, *over the sum of:*
219(1) (a), (b), (c)

(a) the amount of federal income taxes and non-deductible provincial income taxes for the year;
219(1) (e), 219(1) (f)

(b) the amount of the foreign tax credit deducted from the tax otherwise payable for the year under Part I of the Act;
219(1) (g)

(c) an amount equal to ½ of the lesser of the corporation's taxable income and the sum of its net foreign sources incomes and net taxable capital gains;
219(1) (g)

(d) the amount by which the aggregate dividends paid for years since the corporation last became resident in Canada exceeds the amount referred to in (c) above; and,
219(1) (i)

(e) the prescribed allowance for the year for investment in property in Canada.
219(1) (h)

7.079 In the case of a non-Canadian corporation that was at all times during the year not resident in Canada, the additional tax will be levied *on the excess* of the corporation's taxable income earned in Canada plus the preceding year's investment property allowance *over the sum of:*
219(1) (a), 219(1) (b)

(a) the amount of the net taxable capital gains from dispositions of taxable Canadian property not used in carrying on business in Canada; however, this amount may not exceed the corporation's total net taxable capital gains from all taxable Canadian property;
219(1) (d)

(b) the amount of federal income tax and non-deductible provincial income taxes for the year, except any portion of such taxes applicable to the amount of any net taxable capital gain referred to in (a) above; and,
219(1) (e), 219(1) (f)

(c) the prescribed allowance for the year in respect of investment in property in Canada.
219(1) (b)

7.080 Non-Canadian corporations which are resident in Canada will be taxed under Part XIV of the new Act for the 1972 portion of their 1971-1972 fiscal year. There will be no additional tax on such corporations for the 1971 portion of the year since Part IIIA of the old Act does not apply to corporations resident in Canada. Non-Canadian corporations which are non-resident will be taxed under Part XIV of the new Act for the entire period.
ITAR 11(2)

7.081 Corporations which were exempt from this special tax up to 1971 will generally continue to be exempt under the new Act. These corporations and non-resident insurers should make reference to the Act and Regulations where specific information is required.

7.082 It will be noted that the special branch tax applies to corporations, other than a corporation that was, throughout the year, a Canadian corporation, carrying on business in Canada, whether they are resident in Canada or not. The new Act defines a "Canadian corporation" as a corporation resident in Canada and incorporated therein or a foreign-incorporated corporation resident in Canada throughout the period commencing on June 18, 1971. For example, a corporation incorporated in the United States and carrying on business in Canada will be considered a "Canadian corporation" if it became resident in Canada prior to June 19, 1971, and remained resident in Canada continuously since that date; thus, it will not be subject to the branch tax. On the other hand, if the American corporation became resident in Canada after June 18, 1971, it will not be considered as a Canadian corporation and will be subjected to the branch tax.
89(1) (a)

POSTMASTER:

If undeliverable return to Undeliverable Mail Office for forwarding to District Taxation Office.

MAÎTRE DE POSTE:

En cas de livraison impossible, retourner au bureau des rebuts pour transmission au bureau de district d'impôt.

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SERVICE DE SA MAJESTÉ

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